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Source: Business Law/Intellectual Property in Business Transactions/Preface

Preface

More economic growth in the United States comes from intellectual property-based businesses than from any other sector. In today's highly competitive global economy, a company's success depends not only on its ability to develop and manage a valuable intellectual property portfolio internally, but also on its ability to exploit its intellectual property through out-licensing and financing transactions and to acquire new intellectual property through in-licensing, collaborations, and mergers and acquisitions. This book is intended to serve as a practical reference manual for attorneys representing companies in business transactions where intellectual property is a significant and valuable component. It includes many useful sample forms and checklists, as well as practical advice and discussion of applicable law. This book is not intended to replace the nationally oriented multivolume intellectual property treatises, but rather to be a useful reference tool for business and intellectual property lawyers involved "hands on" in intellectual property-related business transactions.

Following is a brief summary of the contents of this book. For a detailed summary of the contents of each chapter, please refer to the outline at the beginning of each chapter. The chapter outlines list each section heading and provide a sequential preview of the topics covered in each chapter.

- Chapter 1, *Managing Intellectual Property Assets*, reviews how a well-managed intellectual property portfolio can further a company's business objectives and describes the best procedures for conducting an intellectual property audit. This chapter also includes sample checklists for intellectual property audits, and sample patent and trademark schedules.

- Chapter 2, *Intellectual Property Valuation*, discusses the three methods of asset valuation—the market approach, the cost approach, and the income approach—and analyzes how these approaches can be used to quantify the value of a company's intellectual property assets.

- Chapter 3, *Structuring Transactions Involving Intellectual Property*, provides an overview of the four principal structures for business transactions involving intellectual property (licensing, strategic alliances or collaborations, partial asset acquisitions, and mergers or complete asset acquisitions) and considers the major advantages and disadvantages of each type of structure.

- Chapter 4, *Intellectual Property Due Diligence*, provides practical guidance for conducting intellectual property due diligence in different types of business transactions in various industries. It explains why due diligence investigations are conducted and establishes a framework for designing an investigation that will be appropriate for the client in a particular transaction. It also includes a sample due diligence checklist for intellectual property.

- Chapter 5, *Intellectual Property Licensing*, presents the basics of intellectual property licensing. It deconstructs a typical intellectual property license agreement, setting forth and analyzing numerous sample clauses from different perspectives, including provisions for royalties, audits, warranties, indemnification, and enforcement of intellectual property rights. It also covers a number of special clauses applicable in licenses of particular types of intellectual property.

- Chapter 6, *Joint Ventures and Strategic Alliances*, addresses the two types of legal relationships that companies may enter into for the purpose of joint exploitation of existing intellectual property rights or joint development of new intellectual property: joint ventures, which entail the formation of a new legal entity, and strategic alliances or collaborations, which are strictly contractual. The chapter includes sample forms of a joint venture agreement and a strategic alliance or collaboration agreement.

- Chapter 7, *Intellectual Property Issues in Merger and Acquisition Agreements*, presents typical representations and warranties that should be included in a merger or acquisition agreement to properly address intellectual property assets. It explains the functions that those clauses perform and provides practical advice for drafting and negotiating those clauses from both the buyer's and seller's perspective.

- Chapter 8, *Related Documents*, considers the ancillary agreements and other documents typically associated with an intellectual property-related merger or acquisition transaction. It provides sample forms of an intercompany confidentiality agreement, intellectual property assignments, employee and independent contractor invention assignments and confidentiality agreements, transition services agreements, and specialized forms of intellectual property licenses. This chapter also includes a sample closing checklist for an intellectual property-related merger or acquisition.

- Chapter 9, *Intellectual Property in Secured Lending Transactions*, is a comprehensive discussion of the applicable law and procedures for utilizing intellectual property as collateral in lending transactions, including creating, perfecting, and determining the priority of security interests in intellectual property and exercising remedies against intellectual property collateral.

- Chapter 10, *Federal Income Tax Issues*, provides a comprehensive overview of the major U.S. federal income tax issues associated with development, ownership, and acquisition or disposition of intellectual property. It also discusses tax structuring considerations involving intellectual property.

- Chapter 11, *Selected International Issues*, addresses selected issues relevant in cross-border transactions involving intellectual

property, including jurisdictional issues, choice of law, choice of forum, U.S. export controls, the Foreign Corrupt Practices Act, privacy and data protection laws, royalty issues, international intellectual property treaties, and European Community competition laws.

- Chapter 12, *Intellectual Property Licenses in Bankruptcy*, is a comprehensive review of the issues arising when either the licensor or the licensee under an intellectual property license agreement becomes a debtor in a bankruptcy case. The chapter focuses on the ability of the bankruptcy trustee (or debtor in possession in a Chapter 11 case) to assume, assign, or reject the license as an executory contract. It also includes sample clauses for license agreements intended to enhance the position of the licensor or licensee, as applicable, in a bankruptcy setting.

- Appendixes A through F contain sample forms of patent, software, and trademark licenses; a set of sample forms for secured lending transactions involving intellectual property collateral; a sample alternative dispute resolution provision, and several alternative intellectual property infringement indemnification provisions.

CEB expresses special thanks to the lead authors of this book: Marc C. Asbra and Brian J. Marler of Houlihan Lokey Howard & Zukin, Los Angeles; Roxanne E. Christ of Latham & Watkins LLP, Los Angeles; Louis R. Dienes of Jeffer, Mangels, Butler & Marmaro LLP, Los Angeles; Timothy J. Fitzgibbon, Stuart P. Meyer, Ralph M. Pais, and Hank F. Dempsey, of Fenwick & West LLP, Mountain View; Stephen D. Gillespie of Fenwick & West LLP, San Francisco; Catherine J. Holland and Mark R. Benedict of Knobbe Martens Olson & Bear LLP, Irvine; David H. Kennedy of Gibson, Dunn & Crutcher LLP, Palo Alto; Stafford Matthews of Sonnenschein Nath & Rosenthal LLP, San Francisco; Jeffrey G. Sheldon of Sheldon Mak Rose & Anderson PC, Pasadena; and John E. Wehrli of Latham & Watkins LLP, Menlo Park.

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Each of the authors and consultants gave generously of his or her knowledge and specialized skills. See "About the Authors" and "About the Consultants" on the following pages for detailed biographical information.

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Selected Developments

March 2010 Update

On May 19, 2009, the American Law Institute approved the final draft of the Principles of the Law of Software Contracts. The Principles are intended to apply to agreements for transfer of software for consideration, including agreements to sell, lease, license, access, or otherwise transfer or share software. Although they do not have the force of law, they may influence judicial decisions in the future. See §5.109A.

Chapter 4 has been expanded to include additional descriptions of the different types of private and public securities offerings and M&A transactions for which counsel may be asked to perform intellectual property due diligence, along with additional discussion of the differing legal standards governing due diligence investigations in these contexts. See chap 4.

Under the first sale doctrine, also known as the exhaustion doctrine, the first unrestricted sale of a patented item exhausts the patentee's control over that particular item. See *Quanta Computer, Inc. v LG Electronics, Inc.* (2008) ___ US ___, 170 L Ed 2d 996, 128 S Ct 2109, 2115. A similar doctrine exists in copyright law. See 17 USC §109. Thus, if a licensee legitimately sells a licensed item, a restriction on what the customer can do with the licensed item may be unenforceable. See §5.24.

A new sample clause for a royalty based on invoice price and new sample recordkeeping and audit provisions have been added to the license forms in chapter 5. See §§5.33, 5.66.

The description of the use of publicity rights as loan collateral has been expanded. See §9.18.

Bills have been introduced in the House of Representatives and the Senate to extend the research credit to apply to amounts paid or incurred on or before December 31, 2020. See HR 422, 111th Cong, 1st Sess (2009) and Growth Research Opportunities with Taxcredits' Help Act, S 1203, 111th Cong (2009). The Obama administration's fiscal 2010 budget proposal (JCS-3-09) proposes to make the research credit permanent. See §10.15.

The temporary Treasury Regulations under IRC §482 concerning the IRS' ability to impute contractual terms in intercompany agreements and to redetermine intellectual property ownership among related taxpayers have now become final. In a departure from past precedent, the regulations provide a three-pronged analysis that, when coupled with the IRS's ability to impute contractual terms, gives the IRS broad authority to disregard a taxpayer's intellectual property ownership structure. See §§10.57, 10.60.

The Obama administration's fiscal 2010 budget proposal (JCS-3-09) proposes to "clarify" the definition of intangible property to include workforce-in-place, goodwill, and going concern value. This would be a significant change to the definition of intangibles under IRC §482. See §10.58.

The Obama administration's fiscal 2010 budget proposal (JCS-3-09) would also provide that (1) in a transfer of multiple intangible properties the Internal Revenue Service may value the intangible properties on an aggregate basis when doing so achieves a more reliable result and (2) intangible property must be valued at its highest and best use, "as it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment, JCS-4-09 (Sept 2009) at 36 37. See §10.59.

On December 31, 2008, the IRS issues temporary and proposed regulations that cover cost sharing arrangements. See IRB 2009-7 (TD 9441) (Feb 17, 2009). These regulations apply on January 5, 2009; however, important grandfather rules apply for existing cost sharing arrangements. See §10.64.

In *Xilinx Inc. v Comm'r* (9th Cir 2009) 567 F3d 482, reversing the Tax Court, the Ninth Circuit stated that "the record conclusively establishes that the companies in a joint venture operating at arm's length do not share [employee stock option] costs," but further held that although the §482 cost sharing regulation in this case required non-arm's length dealings, it nonetheless should be enforced. See §10.67.

The IRS has issued new temporary cost sharing regulations, which are based on the investor model. Under the new temporary regulations, controlled participants share intangible development costs in proportion to their shares of reasonably anticipated benefits by entering into cost sharing transactions. Temp Treas Reg §1.482-7T(a)(1), (b)(1). See §§10.69-10.75.

In *Top Rank, Inc. v Ortiz (In re Ortiz)* (CD Cal 2009) 400 BR 755, the court found that a §365(f) order authorizing the sale of intellectual property free of the licensee's retained license rights under §365(n) was void as to the licensee's license rights because of a lack of notice to the licensee. See §12.39.

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Managing Intellectual Property Assets

Catherine J. Holland
Mark R. Benedict

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§1.1 I. INTRODUCTION

Intellectual property has become big business. Most analysts believe that the worldwide total value of all types of intellectual property, although hard to measure, is between $5 and $10 trillion, with the value of United States patents alone approaching $1 trillion. As international markets become more standardized, and intellectual property protections harmonize and strengthen worldwide, these numbers will almost certainly continue to increase. Any company that fails to understand the role of intellectual property in its operations risks potentially serious losses, *e.g.,* by incurring liability for infringing third party intellectual property rights or by failing to effectively prevent competitors from operating in the company's market segment or otherwise exploiting the company's goodwill and intellectual assets.

Companies that take the time to assess the nature of their intellectual property and understand its potential impact on their business plan may find unexpected treasure troves of value. As a case in point, passage of the Bayh-Dole Act of 1980 (35 USC §200) allowed universities in the United States to create, own, and transfer intellectual property rights derived from government-funded basic research. In the years since Bayh-Dole was enacted, government-funded U.S. universities have learned that it pays to take the time to understand and evaluate their intellectual property. Under Bayh-Dole, universities have established administrative offices to identify faculty innovations, create intellectual property rights encompassing these innovations, and seek commercial outlets for these innovations. By licensing out their intellectual property rights for commercial development, universities in the United States have accomplished the dual goals of transferring publicly funded university technologies back into the hands of the public, while at the same time generating substantial revenues for the universities. (For a sample university license agreement, see §8.27.) Indeed, the value of university-based intellectual property has skyrocketed far beyond the expectations of legislators and university administrators.

This chapter discusses how a company's intellectual property can further its business goals, and suggests mechanisms for creating, recognizing, and managing that intellectual property.

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§1.2 II. BUSINESS STRATEGIES

In today's economy, successful companies typically have characteristics beyond mere low-cost production. Modern companies, even those in low-price-point industries, can capitalize on their nontangible assets such as innovative ideas, creative designs, valuable brands, and proprietary business processes and information. A company that can create, acquire, and take advantage of these intangible assets has a competitive advantage over companies that are unable, or lack the expertise or incentive, to move beyond low-cost production as a core business strategy.

The law recognizes the business value of intangible assets, and distinct areas of intellectual property protection have developed:

- **Patent law** protects innovative and useful machines, articles of manufacture, and processes (see §3.4);
- **Copyright law** protects creative expression (see §3.5);
- **Trademark law** protects company and product identities and brands (see §3.6); and
- **Trade secret law** protects proprietary information that can be maintained as secret (see §3.7).

Companies may rely on one or a combination of these recognized areas of intellectual property law to maximize their competitive advantage.

Typically, companies use their intellectual property to manage competition. By developing an intellectual property portfolio that provides a sufficient scope of exclusivity, companies can preserve design freedom for their tangible products by creating defensive positions around identified design alternatives—thereby keeping competitors at bay. In addition, when a company has an intellectual property portfolio that is perceived by competitors as sufficiently broad and deep, design freedom can also be maintained simply by discouraging competitors from asserting their own patents for fear of infringement counterclaims and protracted litigation. Of course, companies may assert their intellectual property offensively to prevent competitors from marketing infringing or misappropriated products or services. Companies may also leverage their intellectual property portfolio to drive deals with potential partners, customers, and competitors.

A company should also recognize that it may derive other valuable benefits from its intellectual property portfolio besides managing competition. One such additional benefit is generation of revenue through IP licensing. Another benefit of a well-managed intellectual property portfolio may be creation of value, which may be realized in financial analyst valuations, stock prices, investor interest, or as collateral for financings.

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§1.3 A. Excluding Competitors

Intellectual property, especially patents, can be used very effectively to prevent competitors from selling competing products, even if those products have been independently created. Not only can patents prevent competitors from selling the same product, they can also be used to prevent competitors from selling alternative products. Developing a valuable patent portfolio should involve a multilayered approach, in which the core technology or product is patented. Additional layers of protection may be added to expand the scope of exclusivity beyond the company's core technology or product. Such additional layers may include, for example:

- Patenting the commercial form of the product, such as an extended release tablet comprising the core therapeutic composition in a foil blister pack, together with instructions;
- Patenting individual parts of a machine or other combination;
- Patenting foreseeable design-around products, even if such design-around products are viewed by the company as inferior;
- Patenting combinations comprising advantageous features of the company's technology that are incorporated into competitors' product configurations—although the company may not have freedom to practice such combinations, by patenting these combinations, a company can effectively prevent competitors from modifying their competing products based on the company's advantageous features; and
- Patenting barriers to market entry, such as pharmaceutical label claims or chemical intermediates or metabolites.

Although competitors of the patentee company can develop improvements on the company's product, as long as the improved product incorporates the underlying patented subject matter, the original patentee can block the competitor from using its improvements for the life of the patent.

Using intellectual property to exclude, rather than license, may be beneficial in many markets. Consider for example the pharmaceutical market, where maintaining exclusivity is critical to a brand-name pharmaceutical company's ability to recoup its huge investment in research and development (R&D) and in obtaining regulatory approval. Indeed, in enacting the Hatch-Waxman Act of 1984 (21 USC §355(j), 35 USC §271), the United States Congress recognized the essential nature of patent exclusivity to continued pharmaceutical innovation by extending, at least in part, the patent term lost during the regulatory approval process. Thus, excluding competition by securing and asserting a company's intellectual property portfolio may be an essential part of a company's business plan.

In implementing any strategy based on excluding competition, the company must consider the worldwide marketplace. A company must have a patent or trademark in every country in which it seeks to exclude competition. However, the costs of obtaining and maintaining an intellectual property portfolio across several continents are often prohibitively high. Thus, companies should determine for each country or region of potential interest the market value and the cost of securing patents or trademarks. Other factors, such as the likelihood of successfully enforcing intellectual property rights, the types of judicial relief available, and the manufacturing capability of the country, should also be factored into the cost-benefit analysis. For many types of products or technologies, securing intellectual property protection in only a few major countries or regions, such as Europe, Japan, and the United States, may be sufficient to cover the bulk of the worldwide market. Different jurisdictions will be important for different industries. In any case, a well-managed strategy of excluding competitors will necessarily involve difficult decisions related to foreign filing and identifying the jurisdictions where the benefits associated with the exclusionary rights of intellectual property protection justify the costs of securing and maintaining such protection.

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§1.4 B. Protecting Market Share, Product Lines, and Ability to Innovate

A company may choose to enforce its intellectual property or engage in product innovation to maintain a certain market share or to protect the price of its products in the marketplace. These broad goals may be accomplished by a variety of strategies.

One mechanism for protecting market share is patent "blocking," by which a company studies the core technology of its competitor and obtains patents to effectively box in the competitor. Doing so can prevent the competitor from expanding its ability to use or develop a key piece of its technology.

Another method of handicapping competitors is for a business to anticipate the direction of an industry and obtain patents for goods or processes that its competitors will likely need to use in the future. This tactic effectively denies the competitor entry to the developing field.

A third, and somewhat counterintuitive, strategy has come to the forefront in recent years. A business may decide to donate some of its intellectual property to the public domain, and encourage other businesses to make similar donations. In addition to creating goodwill for the business, this strategy creates a less Balkanized industry in which everyone has greater freedom to innovate. Consider the behavior of IBM. Faced with an aggressively protectionist competitor in Microsoft, IBM has donated over 500 patents to the Linux project. IBM's strategy, one assumes, is to spur innovation by others and prevent Microsoft from obtaining too much power in the software industry.

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§1.5 C. Licensing

A patent, trademark, or copyright can be licensed to others to provide a steady stream of income, much as real property may be leased to third parties. For example, the Hoffman-LaRoche patents on polymerase chain reaction (PCR) processes and agents have been successfully and widely licensed by Applied Biosystems to both end-user researchers and middle-man suppliers for billions of dollars. Licensing need not be limited only to receipt of future cash flow. An increasingly popular option is to securitize future cash flow from intellectual property-backed assets. As an example, Royalty Pharma securitized cash flow from licensing a group of 13 drugs, and its commercial paper issue raised nearly a quarter of a billion dollars.

Licensing can also be used for the mutual benefit of two businesses that agree to cross-license their technology. Each company can then market products that incorporate the technology of the other. This is usually viewed as a win-win situation—if there were no such agreement, neither business could market its goods without infringing the rights of the other. Microsoft and Hewlett-Packard both own hundreds of software patents, many of which they cross-license to each other.

Licensing is also useful in the joint venture context, in which independent firms can license technology to a joint venture subsidiary for commercialization.

Intellectual property licensing is discussed in chap 5; joint ventures are discussed in chap 6.

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§1.6 D. Value Creation

Intellectual property can form an important profit center of a business. For example, one fabless semiconductor chip design vendor named Element 14 sold patented and copyrighted circuit designs to chip manufacturers. Element 14 had never manufactured a chip itself, but it was eventually acquired by Broadcom for over $500 million. Companies like Caterpillar and Lucasfilm build profit centers that are ancillary to their core businesses, for example, by leveraging their strong trademark assets for profit. Even if intellectual property does not form the sole profit center of a business, it can play a pivotal role in the profitability and value of a corporation. It has been estimated that all of the physical assets of the Coca-Cola Corporation could burn to the ground and the company would still be worth millions, based on the value of its trade secret formula for the soft drink and its COCA-COLA® trademark.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.7 III. IDENTIFYING INTELLECTUAL PROPERTY OF A BUSINESS

§1.7 III. IDENTIFYING INTELLECTUAL PROPERTY OF A BUSINESS

To fully appreciate the type, quantity, and value of its various intellectual property assets, a company should conduct regular intellectual property audits. Generally, intellectual property audits have one or more of the following goals:

- Identification of existing intellectual property assets;
- Protection of identified assets;
- Identification and protection of potential intellectual property under development;
- Strategic portfolio planning; and
- Risk assessment.

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§1.8 A. Purpose of Intellectual Property Audit

It is important to determine the purpose and scope of an intellectual property audit. It may be performed as part of due diligence for an acquisition, license, or investment, as part of a prelitigation review, or as part of an annual or semiannual in-house review. This chapter focuses on in-house reviews.

The motivation behind an intellectual property audit will likely impact its size, focus, and thoroughness. For example, an audit being performed for due diligence may have a fixed budget, particularly if the intellectual property due diligence is being conducted by an investor, such as a venture capital firm. It may be a very general overview, or it may be directed only toward specific intellectual property assets. Due diligence audits, both from the buyer and target side, usually focus on confirming ownership and recordation of existing intellectual property assets, determining their scope and validity, assigning a value to the assets, and evaluating freedom to operate vis-à-vis third party intellectual property.

Intellectual property audits performed as part of a prelitigation analysis tend to focus on ownership and existing assets and liabilities. Neither due diligence nor prelitigation audits tend to focus on analyzing the underlying processes for creating and managing intellectual property assets or strategic portfolio planning.

Intellectual property audits performed in-house as part of a periodic (*e.g.,* annual or semiannual) review, on the other hand, may focus more on the company's structure and procedures for creating and managing its intellectual property. An audit to analyze and improve intellectual property creation and management and strategic planning is a "future-oriented" exercise, and should be viewed as an investment fundamental to the long-term health of the company.

In any audit situation, but particularly in ones conducted routinely by a company for internal assessment, time and organizational resource constraints necessarily play a role. There may be enough money for a thorough intellectual property review, but insufficient manpower. If that is the situation, one option is to break up the audit into discrete projects performed over time. These projects may be divided by asset class (*e.g.,* a patent audit followed by a trademark audit), by phase (*e.g.,* separating the structural analysis and substantive phases, described in detail in §§1.9-1.18, by an extended period of time), or by operational department (*e.g.,* complete audits of subsidiaries). The way an audit is conducted is often driven by organizational and resource limitations.

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§1.9 B. In-House Audit

There are several types of inquiries that a company should make in performing a thorough in-house audit. These inquiries may be addressed in discrete phases:

- Structure: Analyzing the structure of the company's intellectual property-producing and intellectual property-using departments and establishing management mechanisms. See §1.10.
- Substance: Identifying and evaluating the company's actual and potential intellectual property assets as well as those of its competitors. See §§1.11-1.18.
- Development: Updating and optimizing the company's internal procedures for creating, identifying, using, and exploiting its intellectual property and watching competitors' intellectual property. See §§1.19-1.25.

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§1.10 1. Structural Phase: Analyzing Corporate and Ownership Structure

The structural phase of an intellectual property audit has at least two goals: first, to set up a framework for the company to analyze efficiently its intellectual property assets and related procedures; and second, to create a mechanism that ensures that the ownership of all intellectual property is properly perfected and recorded.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.11 a. Corporate Structure

§1.11 a. Corporate Structure

The auditors should review the corporation, its subsidiaries, and its related companies to determine which parts of the company are innovating, which parts are manufacturing, and which parts are likely to be enforcing intellectual property rights. One approach would be to partition (theoretically) a large organization into distinct business units, making it easier to analyze the creation and use of intellectual property within each (smaller) business unit, and then to analyze the pipelines between business units through which intellectual property may travel.

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§1.12 b. Ownership Structure

One important issue in intellectual property law is ownership. Real property law, the basis for intellectual property law, has carried over into intellectual property a focus on ownership. As many disappointed plaintiffs have learned, with few exceptions, intellectual property rights may be exercised only by owners or exclusive licensees. Even a technical error in the chain of title to a patent may preclude a company from enforcing its rights. For this reason, it is crucial to monitor and control the chain of title for all intellectual property in a company's portfolio. Executory ownership interests flowing from the contractual obligations of inventors or creators to assign their inventions to the company should be perfected by execution of separate assignment documents. See, *e.g.,* the form provided in §8.6. In addition, for patents, copyrights, and trademarks, proper recordation of assigned ownership interests should be confirmed. Recordation of the assignment provides legal notice to the public of the assignment. See, *e.g.,* 35 USC §261. Preferably, license agreements should also be recorded; this is particularly important in jurisdictions outside of the United States where a bona fide purchaser without notice of an ownership or license interest may take free of such interest. Recordation of patent licenses may offer the licensee advantages that include constructive notice to the public and priority over conflicting patent licenses. Thus, it is important in an intellectual property audit to set up internal mechanisms for proper assignment and recordation of all ownership and license interests in intellectual property. Procedures for assignment and recordation of ownership of different types of intellectual property rights are discussed in §§8.4-8.20.

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§1.13 c. Ownership Issues

Problems related to ownership tend to arise in two areas: parent companies versus subsidiaries, and employers versus employees. Assume, for example, that in a parent-subsidiary relationship, the parent company has spun off its research division into a separate subsidiary. The research subsidiary obtains a patent for something that is used either by the parent or another subsidiary, perhaps a manufacturing division. The company wishes to enforce its patent rights against an infringer, and decides that its manufacturing subsidiary is the best positioned to handle the lawsuit. Unless the patent was properly assigned to the manufacturing subsidiary, however, that subsidiary will not be able to bring the lawsuit in its name alone. See 35 USC §281 (statutory infringement remedy granted to patentees only).

Similarly, defects in ownership can arise between employees and employers. For example, in the United States, patent rights, including the right to apply for a patent on an invention, vest in the inventor. See 35 USC §§101, 111(a). The employer of an inventor has no initial rights to the patent, and can only acquire rights by contract (*e.g.,* an agreement with employees to assign all inventions to the employer) or operation of law (*e.g.,* shop rights). A company that does not contract with its employees or consultants regarding the intellectual property that they create may well find itself in the unenviable position of having its former employees or consultants become competitors with all rights to use their patented inventions.

It is important that employment or consulting agreements be in writing and signed by all persons who may contribute to an invention. In addition to implementing contracts related to creation of intellectual property and overseeing assignments and recordation, the company will also need to create a mechanism for identifying which employees or consultants make inventive contributions to a particular patent application. It is important that inventorship, which is a legal inquiry based on the claimed subject matter, be correctly identified. Failure to properly name the correct inventors is a ground for patent invalidity in the United States. See 35 USC §282(2).

NOTE: For further discussion of employment and invention assignment agreements, and sample forms, see §§6.37-6.40, 8.15-8.17.

Developing a structure by which the inventorship and ownership of intellectual property rights can be identified and allocated properly is essential to maintain the enforceability of those rights. Although in many cases defective title in intellectual property assets can be corrected, the process of correction can be time-consuming and expensive. Ownership of intellectual property assets is one area in which it pays to do it right the first time.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.14 2. Substantive Phase: Inventorying and Evaluating Intellectual Property Assets

§1.14 2. Substantive Phase: Inventorying and Evaluating Intellectual Property Assets

The second, or substantive, phase of an intellectual property audit is the one most familiar in concept. The goal of the substantive phase is to identify and evaluate the intellectual property assets of the company as a whole or of individual business units, as well as relevant third party intellectual property. The substantive phase resembles a traditional inventory, but intellectual property assets are not like goods on a shelf. They are intangible, and therefore may be considerably more difficult to detect and inventory. The traditional divisions of intellectual property assets are patents, copyrights, trademarks, and trade secrets, and each kind requires a different focus in the inventory process.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.15 a. Patents

§1.15 a. Patents

Patent assets are generated mainly from innovation in business units tasked with knowledge creation. Patentable ideas are the natural result of any attempt by a business unit to solve a problem. When people get together to develop a structure, process, apparatus, or method to do something better than has been done before, that innovation may be patentable. Patentability may extend to discovering a new drug with useful properties, to developing a new process for loading semiconductor wafers into processing chambers, or to creating a software program to implement a novel online banking system.

In auditing its patent rights, a company will typically organize the inventory on a patent schedule. The schedule will include issued patents and pending applications, both in the United States and aboard. With larger patent portfolios, the patent schedule may be further broken down into company-owned and licensed patents and applications. It is useful to include information such as the internal docket number, application serial number, patent number, filing date, priority date, issue date, expiration date, title, and inventorship. A sample patent schedule is presented in §1.30.

There are a variety of software tools to assist companies in keeping track of their intellectual property assets. For example, portfolio management databases, such as Sciforma PSNext or Planisware 5, are commercially available. Many companies rely on simple spreadsheets, such as Microsoft Excel, to monitor and update their patent schedules. Small companies often rely on their outside patent counsel to maintain their patent schedule. The company patent schedule should be updated regularly because this document may be used for business development, business strategy, accounting, and due diligence.

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§1.16 b. Trademarks

Trademarks are most likely to be generated in a business unit that interacts with customers or suppliers, such as the marketing department. Sometimes, however, trademarks arise from casual usage by the people who are closest to the production or use of the product.

A company will typically organize its trademark inventory on a schedule. The schedule will include registered trademarks and pending applications, both in the United States and abroad. It may be further broken down into different sections, grouping trademarks managed by different divisions or in different licensing programs. It is useful to include information such as the internal docket number, application serial number, filing date, registration number, registration date, maintenance and expiration dates, and ownership and licensee information. A sample trademark schedule is presented in §1.31. The trademark schedule should be regularly updated because it may be used for business development, business strategy, accounting, and due diligence.

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§1.17 c. Copyrights

Valuable copyrightable subject matter can be generated in every business unit throughout the company. Copyright protection extends to the original (although not necessarily innovative) expression of an idea. See 17 USC §102(a). A copyright is born the instant an idea is put down in a fixed format, *e.g.,* in a writing, drawing, photograph, or recording, including electronic media. Although novels and movie scripts are obvious examples of copyrightable materials, more mundane expressions of creativity are also copyrightable: Technical manuals, documentation, office memos, advertising material, and product brochures all may enjoy the protection of copyright law. Computer programs and the company website are also protected by copyright law, even if they do not include patentable innovative ideas.

Copyright registrations, like patents and trademarks, can be organized in a schedule. It would be extremely difficult, if not impossible, however, to collect all of a company's copyrightable subject matter in one place. The best practice is for the legal department to identify the departments that generate the copyrightable subject matter most valuable to the company and to establish a repository for those materials, as noted in §1.25.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.18 d. Trade Secrets

§1.18 d. Trade Secrets

Trade secrets consist of the proprietary information and knowledge of the organization that, as the name implies, are maintained in secret. See CC §3426.1(d) (definition of trade secret). Trade secret assets are most likely to be created in any business unit that develops technical know-how or engages in strategic planning. The technical know-how protectible under trade secret law can be similar to the know-how protectible under patent law. In fact, the two regimes are often viewed as alternatives to each other—if a particular piece of know-how can be protected by a patent, it is likely also protectible as a trade secret. To be protectible, a trade secret must be maintained in secrecy; thus, a product or process that is sold and is readily viewable or reverse-engineered, or is independently discovered, cannot be maintained as a trade secret. On the other hand, formulas that elude reverse engineering or discovery, *e.g.,* the formula for the COCA-COLA® soft drink, may be better protected under trade secret law than under patent law. In each case, the company should decide if its interests are better served by relying on trade secret protection or patent protection.

Unlike patent protection, protection against misappropriation of a trade secret has no fixed term. Trade secret protection can provide a competitive advantage for the company for as long as secrecy can be maintained. Because of this, companies should be cautious when inventorying their trade secret assets, particularly on electronic schedules. Although caution is advised, management should nonetheless maintain an inventory of the company's trade secrets in order to fully capitalize on the potential competitive advantages that the trade secrets may bring to manufacturing, marketing, and other aspects of the business.

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§1.19 3. Development Phase: Creation of New Intellectual Property

In addition to cataloging the existing intellectual property assets of the corporation, a comprehensive audit includes analyzing ways in which a company can increase its production of new intellectual property assets. This process includes promoting the creation of innovative ideas within the company and taking proper steps to perfect the new ideas as intellectual property assets. For example, trademark, copyright, and trade secret protection can exist even if the company does not register its rights with federal or state agencies. Patent protection, however, cannot exist until the U.S. Patent and Trademark Office (PTO) has examined a patent application and issues a patent.

The company must focus both on the process of how innovative ideas or original expressions are generated and the process by which those ideas and expressions are transformed into patents, maintained as trade secrets, or registered with the PTO or the U.S. Copyright Office. Many good ideas simply go unnoticed and unutilized. Any employee, from manufacturing to research, may have a good idea relating to the company, and the idea may be only tangentially related to the employee's job duties. Employees are often hesitant to come forward with their ideas, usually out of fear of looking silly. An organization can overcome these hesitations by putting in place a policy encouraging employees to report innovative ideas to managers. The policy may include monetary or other incentives. Employees should not be made responsible for evaluating the patentability of their ideas with regard to novelty or obviousness, which are evaluations that must be made by lawyers.

The allocation of resources between different types of intellectual property will depend on the business's focus; patents and trademarks are typically the most important for technology companies to develop. The methods described in §§1.20-1.25 can be applied to development of all types of intellectual property.

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a. Developing Patents

§1.20 (1) Patent Committee

The single most important organization-wide tool for promotion of patents is the patent committee. The goal of the patent committee is to act as a cross-business unit authority for patent-related matters. The committee should act as a single overseeing body for all patent-related issues, from production to litigation. If vested with enough authority, the committee will ensure a coherent patent strategy, implemented across multiple business units.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.21 (a) Composition of Patent Committee

§1.21 (a) Composition of Patent Committee

The patent committee should be headed by a chairperson drawn from the executive or senior staff. The chair should have decision-making authority. Proper protection of intellectual property will sometimes align naturally with other interests, such as the synergy between increasing innovation in R&D departments and increasing patentable material. Often, however, implementing an effective intellectual property program will involve imposing additional costs on business units that may not always understand or appreciate the value of the procedures. Clean-room procedures in software development, for example, are costly and may be a hard sell to traditional managers and engineers. It is therefore necessary that the patent committee, through its chair, has sufficient authority to implement its recommendations or else has a direct connection to senior managers in a position to do so.

The patent committee should also include representatives from the technical or engineering departments of the organization—those most likely to understand the innovative activities of the organization and the potential impact of recommendations by the patent committee. The role of the technical staff should be to serve as the eyes and ears of the patent committee. The technical representatives will have a good feel for what sorts of innovation are possible, what procedures will spur innovation, and what are the most innovative ideas likely to develop within the company.

Of course, the patent committee must include representation from the legal department. The legal representative will offer advice on issues such as which types of innovation are likely to be protectible, which procedures must be put in place to ensure protection, steps to take to avoid infringing the intellectual property rights of others, and enforcement and litigation strategies.

The committee should also include senior executives or staff persons from representative departments of the organization. The most effective strategies are likely to arise in brainstorming sessions. These sessions cannot take place solely within the chairperson's head; they must be laid out and discussed by people with diverse viewpoints. Of course, the committee chair should have authority to make final decisions.

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§1.22 (b) Duties of Patent Committee

The duties of the patent committee are several. The committee oversees broad, strategic-level decisions. These decisions begin with an analysis of which of the patent generation and protection strategies identified in the structural auditing phase (see §1.10) should be implemented and which of the assets or liabilities identified in the substantive phase (see §1.15) need to be addressed. The committee should, if appropriate, oversee implementation of the recommendations based on its analysis.

The committee will weigh the costs of applying for a patent against the benefits of exclusivity. The committee may oversee analysis of the competitive landscape to determine how and whether to license patents and how and whether to initiate or handle litigation. Lastly, the committee should raise the level of consciousness of the entire corporation regarding intellectual property. Other executives, management, and staff may not be sufficiently attuned to the value of patents and may not understand the reasoning behind some recommended procedures. To counteract this, the committee may decide to hold meetings at the organization's technical facilities to emphasize the importance of patents in the innovative process.

The committee should not be limited to strategic issues. It should also perform clerical functions that exceed the competence of any single business unit. In particular, the committee should maintain a central repository for patent-related documents. The repository will include patent applications, issued patents, signed and executed employee assignment agreements, completed lab notebooks, and similar materials. The committee may also maintain a library of competitors' patents. To the extent that such records can be digitized, they should be stored in digital form to enhance searching abilities. Finally, the committee may administer employee incentive programs.

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§1.23 (2) Patents: Specific Issues

The importance of proper recordation of patentable ideas cannot be overstated. United States patent law requires that all inventors be named in an application. See 35 USC §§111(a)(1), 116. It is therefore extremely important that patent prosecution counsel have an accurate list of all the people who may have contributed to the idea. All employees should be instructed to give credit to all who participate in a new idea. It is the attorney's job to narrow down the list of inventors to the appropriate people.

It is also extremely important that the company maintain careful records of the exact dates and details of the invention. Under United States law, patent rights are granted to the first to invent, not the first to file a patent application. See 35 USC §§102, 273(b)(1). Accordingly, the company must train its employees to keep scrupulous records.

Employees, especially those with a high likelihood of producing patentable ideas, *e.g.,* researchers, engineers, and other employees in innovative business units, should be counseled to maintain the equivalent of lab notebooks, with dates, descriptive details, and witnesses, if possible. The goal of such a notebook is to provide a date and description of the "reduction to practice" of an invention—a statutory term of art (see 35 USC §273(b)(1)) that means an amount of information sufficient to allow a person who is reasonably skilled in the relevant art to practice (*i.e.,* build or create) the invention. To constitute evidence of a date for reduction to practice, a notebook must be both consistently dated, thoroughly detailed, and corroborated. Potential invention disclosures developed and documented in electronic media should likewise be distributed for corroboration.

For example, a lab notebook that states only that the inventor came up with a new method of culturing pearls, without further detail, would not constitute a reduction to practice, but a notebook that discloses a new method of culturing pearls in four, reasonably well-described steps would likely be viewed as a reduction to practice. A notebook with photographs or diagrams of each step, and detailed descriptions, would almost certainly constitute a reduction to practice.

To promote thoroughness, employees can be rewarded with incentives for maintaining proper notebooks. In addition to recording detailed descriptions of their inventions in lab notebooks (sufficiently detailed to evidence a reduction to practice and to enable another person skilled in the art to carry out the invention), employees should also be encouraged to think as broadly as possible about potential uses of their inventions. Often, the employees in R&D and other innovative business units are most familiar with the relevant patent publications and literature in related fields and are therefore the best able to identify commercially valuable uses for their inventions—even if those uses are outside the focus of their business unit.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.24 b. Developing Trademarks: Trademark Committee

§1.24 b. Developing Trademarks: Trademark Committee

The oversight and management of a company's trademarks is best achieved by a trademark committee comprised of representatives from a company's management, marketing, and legal departments. The focus and work load of the committee will vary, depending on the nature of the company. The manufacturer of a variety of consumer products may need to develop a number of trademarks on a regular schedule. A service provider or original equipment manufacturer may have only a company name or one mark, but may need to expand the use of its name into new markets or countries that it wishes to serve.

To be effective, the committee must include a senior member of the marketing department with the ability to make decisions. This person should establish a procedure within the marketing department for submission of potential marks for new products, with a policy that no marks, advertising slogans, or packaging may be adopted without the approval of the trademark committee. The marketing department should anticipate that it will take a month to obtain this approval. It should therefore submit potential marks early in the process of developing a marketing campaign, and not on the eve of a printing deadline.

The marketing committee member, in combination with company management, should consider the following:

- How best to distinguish its products from those of its competitors;
- The necessity of obtaining a new mark for the new product, *e.g.,* whether there is any advantage over using existing marks;
- Whether the new mark should be linked to existing marks, such as the corporate logo;
- Whether the mark will be easy to register and protect;
- Memorability, ease of pronunciation, and spelling;
- Ease of reproduction in many sizes, colors, and media;
- Lack of offensive connotations in English or foreign languages; and
- Whether the company has a sufficient budget to adequately promote the new mark;

The committee must also include a member of the legal department, who is responsible for educating the marketing department on how to select strong trademarks. The strongest marks are ones that are coined or arbitrary in relation to the goods or services. (For discussion of how trademarks are classified, see generally *Two Pesos, Inc. v Taco Cabana, Inc*. (1992) 505 US 763, 768, 120 L Ed 2d 615, 112 S Ct 2753.) A mark that only suggests the quality of a product may also be strong. Descriptive words, however, make very weak marks and may not be protectible. Marketing departments tend to favor using descriptive marks because they make it easy to communicate the nature of the product to the consumer. In the long run, however, descriptive marks may be more expensive for the company. They are more difficult to register and enforce than are arbitrary or coined marks. The committee member representing the legal department will be responsible for communicating these issues to marketing and to management, so that they can adequately assess the cost to go forward with a particular mark. It is important for the members of the trademark committee to recognize that this tension between the marketing and legal departments is a common problem, and to develop a mechanism for dealing with it.

Once potential marks have been identified, the legal department representative will be responsible for conducting or outsourcing trademark searches to determine the availability of marks and for analyzing the risk of infringement vis-à-vis trademarks owned by other companies. This analysis can be done on both a national and an international level. Based on the risk and cost analysis, the committee can then decide whether or not to adopt the mark.

The trademark committee is also responsible for deciding what steps it will take to protect the mark. For example, it may consider filing state, federal, or foreign trademark applications and enrolling the mark in national or international watching services. In addition, it should determine how aggressively it wishes to enforce the mark against other companies. The legal department representative will be responsible for implementing the committee decisions.

Typically, the legal department maintains the status reports and the files for all trademark clearance searches, applications, registrations, licenses, and enforcement matters. It is helpful if the status reports are digitized and

maintained in a location that can be easily accessed by the trademark committee and the marketing department. Most professional search companies provide an electronic copy of the search report, and these may be stored together in a database to facilitate access and minimize the volume of physical files.

Like the patent committee, the trademark committee should work to raise the consciousness of the entire organization regarding intellectual property. Ideally, it will organize meetings among legal, marketing, sales, and management teams, so that the different departments can work together to identify and protect the distinctive marks, colors, packaging, and trade dress that distinguish the company from its competitors. The committee can also help the company monitor its competitors by engaging outside research and monitoring services that will notify the company when its competitors have filed trademark applications.

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§1.25 c. Developing Copyrights

For companies in the entertainment and software industries, development of copyrightable works is a central feature of their business models. For technology companies, however, or other companies in the business of manufacturing tangible products, copyrightable works may spring into existence without any conscious effort on the part of the company to develop them. It is usually the task of the legal department of a technology company to identify which works may have value to the company, to organize them, and to register them with the U.S. Copyright Office if necessary.

Technical documentation, for example, may be very valuable to a manufacturing company. Competitors trying to copy a company's products may find that it is extremely labor-intensive and expensive to create new technical documentation, especially if that documentation is important to the end-user. Even if a product is not covered by patent or other protections, the copyrights covering the user's manual may constitute a significant stumbling block for a competitor.

Copyright protection also extends to a company's website, which can be a fertile ground for infringement. The legal department should review the company's website and evaluate the potential benefit of registering it, or portions of it, with the U.S. Copyright Office. See generally Internet Law and Practice in California (Cal CEB 2004).

If the company audit reveals that there is substantial, potentially valuable copyrightable material, the legal department may wish to conduct meetings to educate employees with respect to the company's copyrights. One issue common to all companies is the problem of obtaining proper assignments from independent contractors who develop copyrightable works for the company. It is important to have procedures in place to ensure that all independent contractors (and employees working outside the scope of their employment) have written agreements in which they expressly assign their copyrights to the company. For a sample form of independent contractor assignment agreement, see §8.17. See also §§8.11-8.14

Another common issue concerns the employees' use of copyrighted works obtained from sources outside the company, for example, in development of marketing materials or computer software. Of considerable concern for many organizations is the use of copyrighted open-source software programs. Although some so-called "free" software is truly free, the majority of it is highly encumbered with copyright restrictions. These restrictions often take the form of so-called "viral" openness, meaning that a condition for the free use of a copyrighted piece of source code is that any program that includes that source code must be copyrighted under similar terms, namely as open source. Such an open-source requirement normally would pose serious conflicts for an organization that wishes to maintain the secrecy of its source code. It is imperative that any pieces of open source software incorporated in one of the company's products are identified, and that the license under which the open source software is distributed is analyzed by the legal department. For further discussion of this issue, see §8.31.

The legal department may establish a central repository for important copyrightable materials, such as technical manuals, software, or the company's website. Employees should be instructed to deposit a copy of each major version of a work in the repository as the work is created. The copy should be dated, and include the names and titles of all persons who contributed to the work, including employees and independent contractors. The legal department can then evaluate the necessity of obtaining assignments and the desirability of registering the work with the U.S. Copyright Office.

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IV. MANAGING INTELLECTUAL PROPERTY EFFECTIVELY

§1.26 A. The Big Picture

Effective management should work closely with the patent and trademark committees to identify the most important intellectual property assets with respect to the company's evolving business plan and to deploy company resources to maximum efficiency. In deploying resources strategically, management must look beyond the company's own business plan and intellectual property assets. Management should be vigilant for competitive threats to the company's market share as well as for new market opportunities.

High value areas for developing new intellectual property should be identified based on a thorough consideration of the competitive landscape. For example, if competitive pressures are identified as affecting a company product or business segment, management may consider that product or business segment as a high value area and add further layers of patent protection to expand the company's scope of exclusivity or use patent blocking strategies to limit a competitor's space for innovation. Exploiting the company's trademarks through new advertising campaigns may also be seen as a high value area. Management should further consider how the company's copyright and trade secret protection may compliment or bolster its competitive advantage. For technology companies, the stakes tend to be highest in the patent context, where research and development is expensive. Management and the intellectual property committees should allocate and reallocate company resources dynamically to high value areas, always with an eye on the company's position within the industry as a whole.

EXAMPLE: As an example of how an audit can facilitate effective intellectual property management, consider an automobile manufacturer. Many elements of a car can be patented. The company can obtain design patents on the overall appearance of the car (or parts of it) and utility patents on major components such as the engine or smaller elements such as tire treads and air vents. Further, the automotive design and fabrication process is complex, and certain aspects of the process may be capable of process patent or trade secret protection. Not only is there a variety of different types of intellectual property protection available, but management of the different business units may differ significantly in their views of the importance of intellectual property protection. The engine design team may be highly productive and very innovative, but lax in maintaining lab notebooks. The tire tread design team may be vigorous in maintaining detailed notebooks, perhaps to the detriment of its innovative output. A thorough audit of the two business units would reveal the differences in number and kind of patents obtained by each group, as well as the different mechanisms in place in each group to promote innovation. The audit would also evaluate the patents in each area, compare their revenue and cost potential, and make organizational changes as needed, *e.g.,* to enhance recordkeeping in the engine design unit.

Effective management allocates legal resources more efficiently. Even if in-house counsel is used and billing rates are not an issue, patent prosecution is expensive. In general, it is more efficient to seek more patents on more profitable technology (such as automobile engines in the example above) and fewer patents on less profitable technology (such as tire treads in the example above).

Finally, effective management imparts a forward-looking perspective on the entire process of resource allocation. Companies that implement active intellectual property management strategies direct future research, development, and legal costs towards strategic goals in view of the competitive landscape. A company's active portfolio management allows it to focus the development of intellectual property in its most profitable areas. In stark contrast, reactive management tends simply to catalog the company's intellectual property assets uncritically. This can result in a company failing to realize potentially huge areas of profit.

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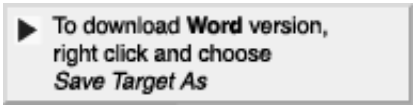
§1.27 B. Sample Checklists for Intellectual Property Audits

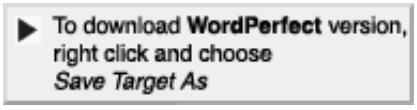
In §§1.28-1.29 are two sample checklists that a technology or other manufacturing company may use in conducting intellectual property audits. The second checklist places greater emphasis on a company's intellectual property agreements and internal procedures.

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.28 1. Checklist No. 1

§1.28 1. Checklist No. 1





Ownership Issues

- Confirm status of assignment trail (chain of title)
- Confirm existence of all applicable assignments
- Confirm existence of assignment provisions in standard agreements
- Employment agreements
- Consultant agreements
- Scientific advisory board
- Key vendors
- Explore potential ownership leaks
- Prior employment obligations of inventors
- University affiliations
- Outgoing obligations in nondisclosure or other agreements
- Licensing relationships
- Review and map in-licensed rights
- Review and map out-licensed rights

Offensive Portfolio Review

- Develop status report from U.S. Patent & Trademark Office and company information
- Develop list of key features of patented and patentable technology
- Conduct patentability search regarding key features and product configurations

Portfolio Strategy Review

- Map key features against independent claims
- Brainstorm key-feature claims with high level management
- Review claims against revenue model (disposables, replacement parts, services, and other factors)

Competitive Watching

- Compile competitor list from company and from search results
- Generate sample competitor patent report for one key competitor
- Evaluate the desirability of a monitoring service

Internal Processes

- Invention disclosure process
- Patent review committee process, composition
- Marketing feedback to IP team

Third Party Patent Review

- Conduct global prior art or former examiner search for key features
- Identify questions that may warrant further review

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.29 2. Checklist No. 2

§1.29 2. Checklist No. 2

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IP-Related Agreements

1. Employee agreements
   - Invention assignment and nondisclosure agreement
   - Invention disclosure forms
2. Nondisclosure/Confidentiality agreements
   - Mutual disclosure
   - In favor of discloser
   - In favor of recipient
3. Independent contractor agreements
   - Research and development consulting agreements
   - Vendor/Manufacturing agreements
   - Consultant agreements
4. License agreements
   - Patent and trademark license agreements
   - Software license agreements
5. Assignment agreement (purchase/sale)
6. Representations and warranties regarding IP
   - Equity offerings/Debt financings
   - IPOs
   - Security agreement
7. Invoice/Purchase order forms
8. Submission of idea agreements

IP-Related Procedures:

1. Employee procedures
   - Lab notebooks
   - Inventorship determination
   - IP policy for employee manual
   - Patent compensation
2. Loss of U.S./foreign patent rights
3. Loss of trade secret rights
4. Previous disclosures/publications

5. Patent monitoring
6. Business plan
7. Business arrangements
8. Internet issues—limitations on liability
9. In-house IP education
10. In-house document control (privileges, admissions, etc.)

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.30 C. Sample Patent Schedule

§1.30 C. Sample Patent Schedule

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SAMPLE

CAL MEDICAL TECH, INC.

PATENT STATUS REPORT

[Date]

Attorney Docket No.	Title of Invention	Country	Status	Application No.	Filing Date	Patent No.	Issue Date
MRB.001PR	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	US Provisional	Closed	60/040,404	09/05/97		
MRB.001A	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	US Utility	Issued	10/222,222	09/05/98	6,666,666	09/05/02
MRB.001VPC	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	PCT International	Closed	PCT/US98/04 040	09/05/98		
MRB.001VEP	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	European Regional	Pending	98222222.1	09/05/98		
MRB.001VCA	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	Canadian National	Issued	2273960	09/05/98	2273960	01/05/03
MRB.001D1	METHODS AND COMPOSITIONS FOR TREATING HEART DISEASE	US Divisional	Pending	11/333,333	08/16/02		
MRB.002PR	DEVICE FOR DELIVERY OF THERAPEUTIC AGENTS TO ISCHEMIC MYOCARDIUM VIA PERCUTANEOUS INTRALUMINAL ACCESS	US Provisional	Closed	60/555,555	08/22/02		

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Source: Business Law/Intellectual Property in Business Transactions/1 Managing Intellectual Property Assets/§1.31 D. Sample Trademark Schedule

§1.31 D. Sample Trademark Schedule

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KNOBBE MARTENS OLSON & BEAR, LLP

U.S. TRADEMARK STATUS REPORT

[Date]

KMOB File No.	Mark	Class(es) Goods/Services	Serial No. / Filing Date	Registration No. / Registration Date	Renewal Date	Status
KMOBE.010T	KNOBBE, MARTENS, OLSON & BEAR, LLP	42: On-line services, namely, providing information regarding the field of intellectual property and providing information regarding intellectual property legal services.	75/206248 12/02/96	2170865 07/07/98	07/07/08	REGISTERED
KMOBE.015T	KMOB	42: Legal services.	75/682814 04/15/99	2340912 04/11/00	04/11/10	REGISTERED
KMOBE.033T	KNOBBE, MARTENS, OLSON & BEAR, LLP	41: Arranging and conducting educational conferences; conducting seminars, workshops and conferences in the legal field and in the field of intellectual property; and educational services, namely, providing educational speakers in the field of intellectual property; training services in the field of intellectual property; and distributing course materials and education materials in connection therewith. 42: Legal services; providing information in the field of intellectual property.	78/328416 11/14/03	2988171 08/23/05	08/23/15	REGISTERED Affidavit of Use due 08/23/11

Print

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KNOBBE MARTENS OLSON & BEAR, LLP

U.S. TRADEMARK STATUS REPORT

[Date]

KMOB File No.	Mark	Class(es) Goods/Services	Serial No. / Filing Date	Registration No. / Registration Date	Renewal Date	Status
KMOBE.036T	INTELLECTUAL PROPERTY LAW - DOWN TO A SCIENCE	41: Arranging and conducting educational conferences; conducting seminars, workshops and conferences in the legal field of intellectual property; and educational services, namely, providing educational speakers in the field of intellectual property; training services in the field of intellectual property; and distributing course materials and education materials in connection therewith. 42: Legal services; providing information in the field of intellectual property.	78/549063 01/18/05	3178136 11/28/06	11/28/16	REGISTERED Affidavit of Use due 11/28/12
KMOBE.040T	IP IMPACT	41: Education services, namely, arranging and conducting educational conferences; conducting seminars, workshops and conferences in the legal field and in the field of intellectual property; and educational services, namely, providing educational speakers in the field of intellectual property; training services in the field of intellectual property; and distributing course materials and education materials in connection therewith.	78/933823 07/20/06			PENDING; Published



SAMPLE

KNOBBE MARTENS OLSON & BEAR, LLP

FOREIGN TRADEMARK STATUS REPORT

[Date]

KMOB File No.	Countries	Mark	Class(es) Goods/Services	Application No./ Filing Date	Reg'n. No./ Reg'n. Date	Renewal Date	Status
KMOBE.033WWO	United Kingdom South Korea	KNOBBE, MARTENS, OLSON & BEAR, LLP	41: Arranging and conducting seminars, workshops and conferences; teaching; educational information; instruction services. 42: Patent attorney services, lawyer services, copyright management services, arbitration services, intellectual property watching services, licensing of intellectual property, intellectual property cosultancy; on-line services, namely, providing information regarding the field of intellectual property and providing information regarding intellectual property legal services.	Z1230291 01/20/04	IR 822807 10/20/05	01/20/14	REGISTERED *International Registration under Madrid Protocol

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2

Intellectual Property Valuation

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Brian J. Marler

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§2.1 I. IMPORTANCE OF INTELLECTUAL PROPERTY

Numerous studies have noted the increasing importance of the services and technology sectors to United States economic growth. In fact, the contribution of these sectors to U.S. private Gross Domestic Product (GDP) expanded from approximately 53 percent in 1970 to roughly 72 percent in 2008. (Source: Bureau of Economic Analysis. Private GDP excludes federal, state and local governments.) The services and technology sectors are characterized by companies rich in intellectual property (IP) assets.

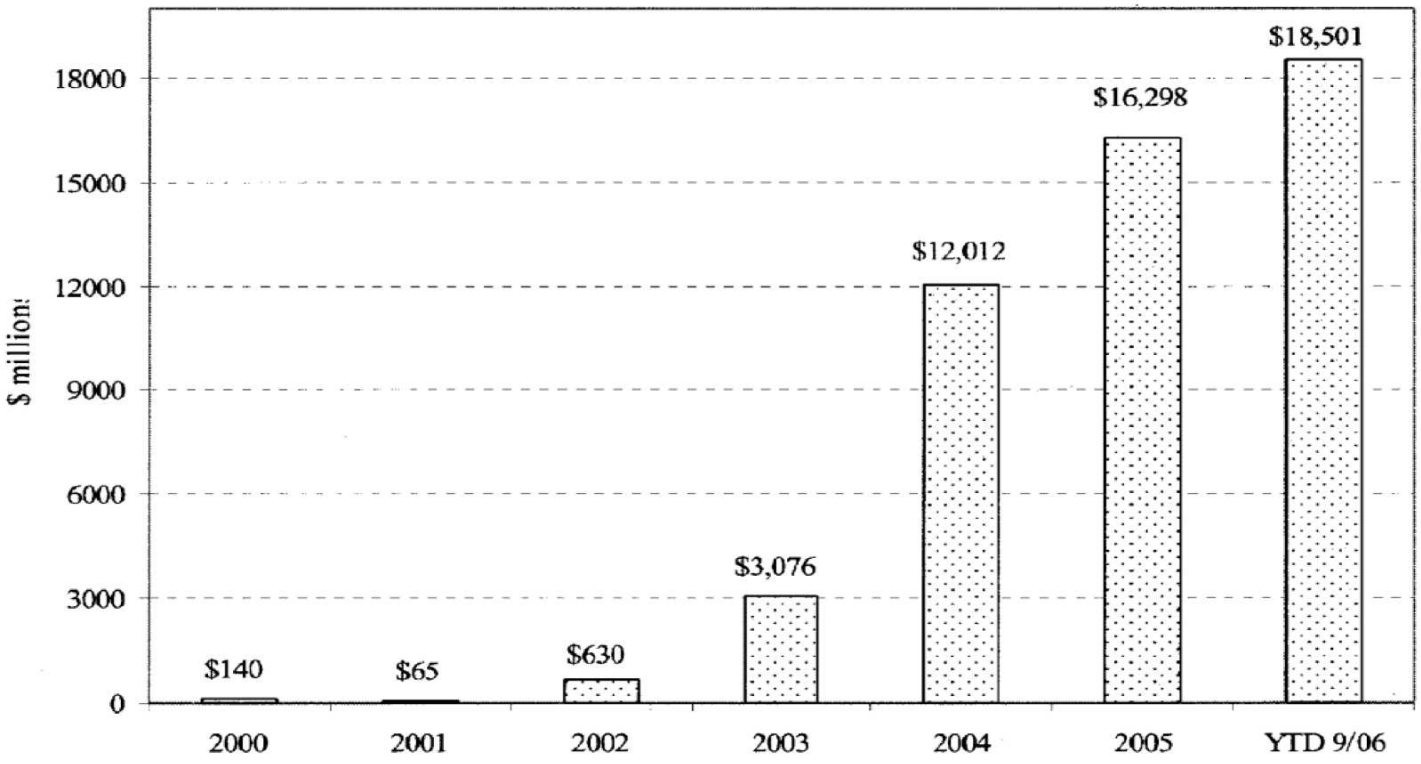
The increasing importance of IP assets to the domestic economy has been paralleled by an equally impressive rise in the U.S. stock market. The rise is most readily apparent from trends in price-to-book-value multiples, which measure a company's market value per share relative to its book equity value per share. From 1980 to 2008, the price-to-book-value multiple of companies in the S&P 500 index increased roughly 75 percent, from 1.3 to 2.3. The valuation multiple reached its zenith in 1999 at 5.1, as strong mergers and acquisitions (M&A) activity and the Internet bubble encouraged unsustainable stock price appreciation, but fell to a 25-year low of 1.2 in March 2009, as global economic conditions deteriorated substantially from prior years. As most IP assets are not reflected in a company's book equity value under generally accepted accounting principles (GAAP), the dramatic increase in the price-to-book-value multiple during the 1980-2008 period demonstrates the investing public's perception that a company's value is increasingly attributable to its IP assets, and not necessarily to its investment in property, plant, and equipment.

In addition to the investing public, lenders and other debt capital providers have also recognized the importance of a company's IP assets, as evidenced by the increasing number of loans underwritten on the basis of a company's cash flow or enterprise value (EV). In contrast to asset-based lending, EV underwriting focuses on the going concern value of a business enterprise, which in turn emphasizes the sustainability of cash flow, quality of management, size of market share, and existence of IP assets.

The explosion of the second lien loan market through 2007 provides a dramatic illustration of trends in the EV loan market (see Figure 1). As the name implies, second lien lenders have a subordinate position to the senior secured capital providers, but enjoy a higher ranking in the capital structure compared to mezzanine lenders and high yield bond holders. Similar to other segments of the debt capital markets, issuance of second lien paper in 2008 and the first half of 2009 was severely impacted by the "credit crunch" that developed in the latter part of 2007.



Figure 1: Second Lien Loan Volume



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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.2 II. COMMON FORMS OF INTELLECTUAL PROPERTY

§2.2 II. COMMON FORMS OF INTELLECTUAL PROPERTY

Intellectual property assets can take several forms. Statement of Financial Accounting Standards No. 141 (SFAS 141R), which was issued by the Financial Accounting Statements Board in June 2001 (and subsequently revised in December 2007) to provide guidance on the valuation of tangible and intangible assets within the context of financial reporting for business combinations, provides a list of commonly identified IP assets. As shown in Figure 2, SFAS 141R identifies five general categories and provides several examples within each category.

Figure 2: Common IP Asset Categories

Artistic-related intangible assets
Plays, operas, ballets
Books, magazines, newspapers, other literary works
Musical works
Pictures, photographs
Video and audiovisual material (motion picture, music, TV)

Customer-related intangible assets
Customer lists
Order or production backlog
Customer contracts and related customer relationships
Noncontractual customer relationships

Technology-based intangible assets
Patented technology
Computer software and mask works
Unpatented technology
Databases, title plants
Trade secrets (secret formulas, processes, recipes)

Contract-based intangible assets
Licensing, royalty, standstill agreements
Advertising, construction, management, supply contracts
Lease agreements
Construction permits
Franchise agreements
Operating and broadcast rights
Use rights (drilling, water, air, mineral, timber cutting)
Servicing contracts (mortgage)
Employment contracts

Marketing-related intangible assets
Trademarks, trade names
Service marks, collective marks, certification marks
Trade dress (unique color, shape, package design)
Newspaper mastheads
Internet domain names
Noncompete agreements

Although the list in Figure 2 is fairly comprehensive with nearly 30 forms of IP assets, additional IP asset types can be identified, including:

- Customer service capability and product or service support
- Presence in geographic locations or markets

- Retail shelf space
- Manufacturing processes, procedures, and production lines
- Assembled work force and trained staff
- Non-union status, strong labor relations, and favorable wage rates
- Ongoing training and recruiting programs
- Favorable government relations

These and other IP assets may be important to a company's operations, but their value tends to be difficult to quantify separately from the general goodwill of a business. In addition, these ambiguous assets can manifest themselves in other, more commonly identified IP assets. For example, "customer service capability and product or service support" can be related to customer relationships or the company's trademark and trade name. The "retail shelf space" that a company possesses at various store locations can be correlated to its customer contract and relationship assets. Thus, these ambiguous assets are rarely identified and valued as separate IP assets.

Before attempting to value an IP asset using commonly accepted valuation methods, care must be taken to ensure that the subject IP asset is capable of being separated from the goodwill of the business.

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§2.3 III. VALUATION METHODS

The fundamental premise on which all investment decisions are based is that value to a potential investor is equal to the present worth of future benefits. This basic concept can be applied across a spectrum of investments, ranging from raw land, in the most tangible sense, to an undocumented business process, in the most intangible manner. In each instance, valuation is a matter of identifying the future benefits expected from the investment, and determining their present value in the context of the uncertainty associated with realizing those benefits.

Whether investments take the form of specific assets or entire companies, the conceptual framework used to measure value is governed by three approaches: the market approach, the cost approach (also referred to as the asset approach), and the income approach.

- The *market approach* (see §§2.4-2.8) estimates value based on what other participants in the market have paid for similar assets. Adjustments are made to compensate for differences between these similar assets and the asset being valued.
- The *cost approach* (see §§2.9-2.11) determines the value of an asset by estimating its replacement or reproduction cost. The cost to replace the asset would include the cost of constructing a similar asset of equivalent utility at prices applicable at the time of the valuation.
- The *income approach* (see §§2.12-2.23) derives the value of an asset by estimating the net economic benefit (*i.e.,* earnings or cash flows) to be received over the life of the asset, discounted to present value. The discounting process uses a rate of return that accounts for both the time value of money and investment risk factors.

Most nonvaluation professionals normally conceptualize these approaches when contemplating the purchase or sale of investment real estate. For example:

- *Market approach*. What was the selling price of the apartment complex two blocks down the street? How many units are in the complex? What was the implied selling price per unit or per square foot? How does its general condition compare to others in the area? Does it have (or lack) unique features such as upgraded appliances, a swimming pool, air conditioning, or hardwood floors?
- *Cost approach*. How much would it cost to purchase a vacant lot or a teardown complex and construct a new apartment building in the same or similar area? What is the cost per square foot for new construction? What is the amount of wear and tear on the subject complex?
- *Income approach*. What are the gross and net monthly cash flows for the complex? Is the rental history stable or variable? What is the current level of occupancy? How do current rents compare to other units in the nearby market? Can they be increased to enhance cash flow?

Determining the value of an entire operating company is conducted by examining factors very similar to the real estate-related questions above, but with slightly different words. What is the price-to-earnings (P/E) ratio for the company and how does that figure compare to its peers (market approach)? How much residual proceeds would be available to shareholders in the event the company sold its assets and satisfied its liabilities (cost or asset approach)? What amount of future dividends or capital appreciation, or both, can be anticipated from the company's stock (income approach)?

Operating companies are a collection of assets, tangible and intangible. Insofar as the market, cost, and income approaches can be used to determine the value of a company in the aggregate, so too can these general approaches be employed to quantify the value of a company's IP assets. The choice of which approach to use in a particular situation will depend on the specific facts and circumstances associated with the IP asset, as well as the purpose for which the valuation analysis is being conducted.

Following is a discussion of each approach, along with descriptions of commonly used valuation methods for IP assets.

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§2.4 A. Market Approach

The market approach measures value based on what other purchasers in the market have paid for assets that can be considered reasonably similar to those being valued. There are five steps involved in using this approach:

(1) Choosing transactions involving comparable intellectual property assets for comparison purposes.

(2) Establishing relevant financial and other data for the IP assets to be analyzed.

(3) Performing a comparative analysis between the subject IP asset and those in the comparable transactions.

(4) Selecting appropriate valuation metrics for the subject IP assets based on the comparative analysis.

(5) Determining the value of the subject IP asset.

Step one of the market approach can be extremely difficult for most intellectual property assets. Unlike real estate, machinery, and equipment assets or entire companies, transactions involving individual IP assets are uncommon. For those IP transactions that are identified, the financial and other data necessary for analysis under steps two and three are rarely available. As a result, the market approach is seldom used to value IP assets.

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§2.5 1. Customer Lists

One instance where the market approach can be employed involves the valuation of customer lists. Customer list rental rates can be obtained from various direct marketing sources, including SRDS Direct Marketing List Source, a publication of Standard Rate and Data Service (SRDS). Lists can be obtained for nearly any conceivable subject area, and are typically priced per one thousand customer names. For example, a list of current subscribers of *Art of Motherhood* can be rented for a base price of $90.00 per 1000 names, and a list of noncurrent subscribers who purchased the publication within the last 180 days can be rented for $60.00 per 1000 names.

EXAMPLE: ABC Company maintains a database of information on its customers, including their contact information, date of first purchase, unit and dollar purchases since inception, and other relevant information for the account. The company considers its "current" customers to be those who have purchased products within the last 3 months. ABC's current customers number roughly 35,000, whereas the company's total customers over the last 12 months are approximately 120,000. Based on an analysis of rental rates for reasonably similar customer lists, rental rates of $105.00 and $70.00 per 1000 names are estimated for ABC's current and other customers, respectively. As shown in Figure 3, ABC management believes the company could sell each customer list to 20 distinct buyers. Based on these assumptions, the total value of ABC's customer list is approximately $193,000.

Figure 3: Customer List Valuation Under the Market Approach

Current Customers:	
Number of Customers	35,000
Price per 1,000	$105.00
Number of Buyers	20
Subtotal, Current Customers	$73,500
Other Customers:	
Number of Customers	85,000
Price per 1,000	$70.00
Number of Buyers	20
Subtotal, Other Customers	$119,000
Indicated Value (Rounded)	**$193,000**

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.6 2. Spectrum Licenses

§2.6 2. Spectrum Licenses

Spectrum licenses provide another case where the market approach can be employed to estimate value. The Federal Communications Commission (FCC) periodically conducts auctions of licenses across the United States communications spectrum. The FCC Advanced Wireless Services (AWS) Auction No. 66 was closed on September 18, 2006 with 104 winning bidders paying $13.7 billion for 1,087 licenses in the 1710-1755 MHz and 2110-2155 MHz bands. AWS is the collective term used for new and innovative fixed and mobile terrestrial wireless applications using voice and data content (*i.e.,* Internet browsing, message services and full-motion video). As shown in Figure 4, the larger and more densely populated cities generally received the highest provisional winning bid (PWB) per POP ("point of presence," which means essentially "per person").

Figure 4: FCC Advanced Wireless Services Auction No. 66 (Final)

Top PWBs

Cellular Market Area (CMA)	Provisional Winning Bidder	PWB $	POPS	PWB per POPS
New York City	T-Mobile License LLC	$396,232,000	16,134,166	$24.56
Chicago	T-Mobile License LLC	254,821,000	8,091,720	31.49
Los Angeles	Cingular AWS, LLC	179,161,000	15,620,448	11.47
Washington	Cricket Licensee	133,150,000	4,182,658	31.83
Philadelphia	Cricket Licensee	82,565,000	5,036,646	16.39
Detroit	T-Mobile License LLC	65,187,000	4,775,452	13.65
Dallas	Cingular AWS, LLC	50,682,000	5,120,721	9.90
Baltimore	Cricket Licensee	43,657,000	2,512,431	17.38

*** Source: Federal Communications Commission*

As in the valuation of a customer list, the pricing information obtained from the FCC auctions can be used to value similar spectrum licenses. Ideally, the data utilized in the valuation would involve identical licenses, cover comparable market areas, and transpire from contemporaneous auctions. In practice, however, adjustments are typically necessary to account for differences in these and other factors. Adjustments related to population size, density, and socioeconomic factors can be made by analyzing results from other auctions. Adjustments related to time are more difficult, as the value of all FCC licenses may have increased since the date of the initial auction due to increased prevalence and usage of wireless applications, further investments made in network infrastructure, and changes in other supply and demand factors. In the event that no contemporaneous auction data is available, a more robust analysis may be accomplished through the use of other valuation methods under the income approach, as described in more detail in §§2.12-2.23. However, value indications obtained from a market approach may be used to corroborate those derived from other valuation approaches.

EXAMPLE: In FCC Auction No. 58, conducted in January 2005, Carroll Wireless, LLC acquired a license to the C block of the broadband PCS spectrum covering Lafayette, Indiana. Broadband PCS encompasses a variety of mobile and portable radio services, using such devices as small, lightweight, multifunction portable phones, portable fax machines, and advanced devices with two-way data capabilities. At that time, Carroll Wireless paid $413,000, or $1.50 per POPs, for its license. Although outliers exist, the price paid by the company is generally similar to prices

paid in comparable market areas. Presume that approximately 2 years later, the company intends to sell the license to a third party and is seeking to estimate its value. As shown in Figure 5, a current value estimate for the license is derived by adjusting the price paid in the FCC auction by changes in population and market factors since that time. The population growth factor is based primarily on demographic trends from historical data. The market adjustment factor considers increases in statewide PCS device usage and average revenue per user statistics obtained from analyzing trends in wireless carriers. Based on these assumptions, the total value of the FCC license is approximately $458,300.

Figure 5: FCC License Valuation Under the Market Approach

Selected Market Areas	Gross Price**	POPs **	Price per POPs
Lakeland-Winter Haven, FL	$762,000	483,924	$1.57
Melbourne-Titusville, FL	714,000	476,230	1.50
Poughkeepsie-Kingston, NY	687,000	457,899	1.50
New London-Norwich, CT	552,000	368,179	1.50
Hickory-Lenoir-Morganton, NC	539,000	341,851	1.58
Olympia-Centralia, WA	488,000	325,360	1.50
Gainesville, FL	626,000	320,199	1.96
Lafayette, IN	413,000	275,303	1.50
Fort Collins-Loveland, CO	396,000	251,494	1.57
Lafayette, IN Population at Auction Date			275,303
Population Growth Factor			2.0%
Lafayette, IN Population at Current Date			286,425
Price per POPS at Auction			$1.50
Range of Market Adjustment Factor			5% to 10%
Estimated Price per POPS at Current Date			$1.60
Indicated Value (Rounded)			**$458,300**

*** Source: Federal Communications Commission*

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§2.7 3. Music Publishing Catalogs

Although entertainment-related IP assets are typically valued using the income approach, the market approach may be employed when valuing music publishing catalogs. Unlike music catalogs comprised of master rights (*i.e.,* the right to license the mechanical reproduction of songs), publishing catalogs provide for the right to collect worldwide publishing royalties on the songwriter's behalf. There are four primary means by which a publishing catalog can generate income:

- **Performance royalties.** Royalties earned from public performances, radio and television airplay, restaurants, and retail outlets as administered by performing rights societies (ASCAP/BMI/SESAC/Sound Exchange).
- **Mechanical royalties.** Payments received for the manufacture and distribution of songs on CDs, records, tapes, and certain digital uses based on the current statutory rate.
- **Synchronization fees.** Fees for the use of a song as an accompaniment to a film or television program.
- **Print income.** Royalties received for the publication of a song in sheet music or a folio, based on a percentage of retail sales.

The contractual agreement between a copyright owner (composer) and music publisher typically provides for a 50:50 sharing of all royalty income generated from the publishing catalog. The music publisher's share of the royalty income is referred to as the "net publisher's share" (NPS).

Due to their recurring cash flow, music publishing catalogs are typically valued based on multiples of NPS, which are obtained from third party transactions. As no publishing catalog is identical to another, when selecting an appropriate NPS multiple for the subject publishing catalog, the valuation specialist must carefully review recent transaction data of comparable catalogs to determine their similarity and relevance to the subject catalog. Such considerations include consistency of annual cash flows, types of royalties earned, quality of the artist(s) included in the catalog, length of publishing rights (rights may revert back to the songwriter at some point in the future), and historical exploitation efforts in licensing the catalog. As shown in Figure 6, over the last 5 years various catalogs have transacted at NPS multiples ranging from 6.8x to 30.9x, illustrating the importance of carefully evaluating the characteristics of the subject catalog relative to the third party transactions.

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Figure 6: Music Publishing Catalogs Transactions - NPS Multiples

$ millions

Announced	Target	Acquiror	Price	Net Publisher's Share	EV / NPS Multiple	Comments
Jun-09	Richard Marx Catalogue	Chrysalis Group	$ 8.0	$ 0.8	10.0	Included a $7.5 million cash payment and $0.5 million based on future NPS.
Mar-08	Zomba U.K., 19 Songs, 19 Music and BBC Catalogues	CPM/ABP	189.0	12.6	15.0	Included the works of more than 100 writers.
Sep-06	BMG MP	Universal Music Group (Vivendi)	2,090.0	215.0	9.7x	All cash offer for 100% stake from Sony BMG.
Dec-04	Elvis Presley Enterprises (1)	Sports Entertainment Enterprises	117.6	12.4	9.5x	$100 million purchase of an 85% stake in the Elvis Presley music publishing catalog, as well as associated real estate investments and trademarks/tradenames.
Apr-04	Jobete	EMI MP	400.0	20.0	20.0	All cash offer of $80 million for remaining 20% stake.
Oct-03	Boosey & Hawkes	HgCapital	63.4	9.3	6.8x	All cash offer outbidding Regent Street Music in a competitive process.
May-03	Trio/Quartet	Windswept Pacific	60.0	3.5	17.1x	Acquired catalog of over 20,000 titles, including "What a Wonderful World" and "Fever."
Apr-03	Jobete	EMI MP	346.3	17.0	20.4x	All cash offer of $103.9 million for additional 30% stake in following 1997 purchase.
Nov-02	Zomba MP	BMG MP	1,080.0	35.0	30.9x	Publishing value estimated at 40% of $2.7 billion purchase of Zomba; Bertelsmann was caught by a poorly considered put option and possibly overpaid; may not be representative.
Jul-02	Acuff Rose	Sony MP	157.0	9.7	16.2x	All cash offer for 55,000 strong country music catalog.
Mar-01	Chrysalis	Securitization	260.0	12.8	20.3x	$60 million for 40%; unclear how much of the catalog was secured.

(1) Reflects EBITDA and EBITDA multiple for the Elvis Presley transaction.
Source: Company filings, analysts' reports, press releases, and news media.

EXAMPLE: XYZ Company owns a music publishing catalog, which it plans to use as collateral for acquisition financing. The catalog has generated consistent royalty income over the last 5 years due to its mix of well-known artists across an array of music genres. XYZ reported gross royalty income of $8 million last year. After comparing the characteristics of the subject catalog to music catalogs sold in recent transactions, an NPS multiple of 11x was selected to value the XYZ catalog, resulting in a value of $44 million.

Figure 7: Music Publishing Catalog Valuation Under the Market Approach

$ millions

Gross Royalty Income	$8.000
Net Publisher's Share @	50%
Net Publisher's Share	4.000
Selected NPS Multiple	11.0x
Indicated Value	**$44.000**

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.8 4. Filmed Entertainment Assets

§2.8 4. Filmed Entertainment Assets

Similar to music publishing catalogs, third party transactions can be found involving the purchase and sale of film libraries. As shown in Figure 8, on certain occasions the transaction price and number of titles in the library are publicly available, which can be used to calculate "price per title" multiples. Other quantitative data for the libraries or titles rarely exist, however.

Figure 8: Film Library Transactions - Average Price Per Title

$ millions Announced	Library Acquired	Buyer	Transaction Price	Titles	Price Per Title
Oct-06	Crown Media - Domestic Rights	RHI Entertainment	$160.0	620	$0.258
Sep-06	Franchise Pictures	David Bergstein	30.7	72	0.426
Jul-05	Good Times Entertainment	Gaiam	40.0	2,000	0.020
Apr-05	Fireworks Entertainment	Content Films International	29.0	350	0.083
Feb-05	Crown Media - International Rights	3i and Providence	180.0	580	0.310
Feb-05	American Vantage (Wellspring Library)	Genius Products	16.0	1,000	0.016
Sep-04	MGM	Sony	4,850.0	4,000	1.213
Jul-01	Hallmark Entertainment Distribution	Crown Media	715.0	700	1.021
Jan-99	ITC	Carlton Communications Plc	150.0	300	0.500
Oct-98	Polygram	Metro-Goldwyn-Mayer	235.0	1,300	0.181
June-98	International Movie Group	Lions Gate Entertainment	3.0	32	0.094
Dec-07	CDR	Polygram	225.0	1,051	0.214
Apr-97	Orion	MGM (P&F Acquisition)	573.0	2,200	0.260
Apr-07	LIVE	Richland, Gordon & Co.	136.0	2,000	0.068
Apr-97	Cinergi Pictures	Walt Disney	38.0	11	3.455
Apr-97	Rank Group Plc	Carlton Communications Plc	107.0	740	0.145
Feb-97	Roger Corman	Elliot Kastner	100.0	378	0.265
Jul-96	MGM	P&F Acquisition	1,300.0	1,559	0.834
Feb-96	Goldwyn	Metromedia	115.0	850	0.135
Jan-96	Lumiere	UGC D.A.	235.0	2,000	0.118

Although a price-per-title multiple can be used to produce a value indication for a subject film library, relying solely on this market-based approach is imprudent. Moreover, using transaction data even as a reasonableness check on the values obtained under the income approach is typically ill-advised due to limited public data regarding a library's future income and licensing potential.

As a point of reference, in a United States Tax Court opinion dated May 12, 2005, *Santa Monica Pictures, LLC v Commissioner of Internal Revenue Service* (2005) TC Memo 2005-104, two expert witnesses were asked to opine on the value of the EBD film library. Both experts relied on a discounted cash flow methodology under the income approach in valuing the EBD library. Although neither expert relied on the market approach, each expert considered a price-per-title analysis based on selected transactions to serve as a reasonableness check on their concluded values. Perhaps not surprisingly, both experts identified film library transactions with implied price-per-title multiples that they considered as corroborative to their value conclusions. As shown in Figure 9, however, the basis for that determination is not readily apparent.

Figure 9: Comparison of Expert Testimony

	Price Per Title
Transaction	

Considered	Expert #1	Expert #2
New Line	$2,500,000	—
MCA	356,725	—
Matsushita Electric	331,395	—
Orion/Samuel Goldwyn	286,500	—
Crédit Lyonnais	232,143	—
Live Entertainment	—	68,000
Expert Opinion	$140,000	$24,219

Each expert's decision to exclude the market approach in deriving value conclusions was presumably due, in part, to the lack of relevant comparable film library transactions with sufficient data available for analysis, particularly future cash flows and availabilities (*i.e.,* future ability to license product). Absent such data, valuation multiples implied from third party transactions may be erroneously applied.

EXAMPLE: Consider a hypothetical transaction in which ABC's 115-title film library was sold on December 31, 2005 for $10 million. Figure 10 illustrates actual first television broadcast cash flows for 2004 and 2005, and projected second television broadcast cash flows for the 5 years ending December 31, 2009:

Figure 10: Hypothetical Film Library Cash Flows and Availabilities

$ thousands **For the Years Ending December 31,**

		2004A	2005A	2006P	2007P	2008P	2009P	2009P
Library Cash Flow								
Australia		300					100	
Canada			200			50		
France		400				120		
Germany		800					200	
Italy			400					
Japan			1,000			300		
Latin America		500				125		
South Korea			450				135	
Spain			300			90		
United Kingdom			1,000				300	
USA		2,000						
Rest of World		200	200	100	100	200	150	150
Total Gross Cash Flow		**$4,200**	**$3,550**	**$100**	**$100**	**$885**	**$885**	**$150**
Less:								
Distribution Fees	15%	630	533	15	15	133	133	23
Distribution Costs	5%	210	178	5	5	44	44	8
Residuals & Participations	10%	420	355	10	10	89	89	15
Pre-Tax Cash Flows		**$2,940**	**$2,485**	**$70**	**$70**	**$620**	**$620**	**$105**

Horizontal dotted lines below entries indicate duration of rights licensed to third parties.

The ABC deal suggests a price-per-title multiple of approximately $87,000, a 2005 year-end cash flow multiple of 4.0x ($10 million divided by $2.485 million), and a 2-year average cash flow multiple of 3.7x ($10 million divided by $2.713 million). However, the historical cash flows are not representative of future cash flows because the ABC library does not retain distribution rights in key territories until 2008 or later. In addition, first broadcast or first cycle television license fees are typically much greater than subsequent licenses, resulting in lower expected cash flows and a much higher implied forward multiple of cash flow.

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§2.9 B. Cost Approach

The cost approach measures value based on the cost to replace the subject asset or to reproduce a similar asset of equivalent utility at prices applicable at the time of the valuation analysis. Once the replacement or reproduction costs have been determined, allowances for functional and economic obsolescence are considered.

- *Functional obsolescence* is the loss in value from internal factors that cause the asset to operate or function less efficiently when compared to an asset of current technology. These inefficiencies may cause surplus capital costs, excess operating costs, and lack of utility, among other things.
- *Economic obsolescence* is the loss in value due to factors external to the asset. These factors may be caused by market conditions, environmental or other regulations, adverse economic situations, and other factors.

The cost approach can be considered for most IP assets, but this approach is best suited for IP assets that are not directly associated with the production of future income or cash flow. The value of income-producing assets would be more appropriately estimated through the use of the market or income approach. When the cost approach is used to value income-producing IP assets, the indicated asset values tend to be lower than those derived under other approaches.

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.10 1. Proprietary Technology

§2.10 1. Proprietary Technology

Although many high technology companies develop technology that manifests itself in licenses sold to third parties, some non-technology companies develop expertise, know-how, or skills for their internal use. This proprietary technology can span across many aspects of a company's operations, from its unique manufacturing process to its customized software modules developed for an internal customer relationship marketing (CRM) program.

EXAMPLE: XYZ, Inc. has developed certain proprietary technologies over the past 2 years. The company does not license the technologies to third parties, but rather uses them for business operations. Value is estimated under the cost approach by identifying the key elements of the proprietary technology, estimating their replacement cost new (RCN), and making adjustments for obsolescence. The RCNs are developed based on estimates of the hours necessary to re-create each element and the hourly salaries of the company's engineers. XYZ also reviewed its internal records and obtained the costs incurred in hiring external consultants for a portion of the original software development effort. As shown in Figure 11, the RCNs are adjusted by various obsolescence factors, which give consideration to the age of the elements, historical depreciation trends, and expected remaining utilization. With respect to the external software development effort, adjustments are made to the RCNs to remove excess costs that are attributed to project inefficiencies. These excess costs would not be repeated in the event XYZ embarked on the effort a second time, nor would a third-party buyer of the proprietary technology be willing to pay for such costs. Based on these assumptions, the total value of XYZ's proprietary technology is approximately $3.4 million.

Figure 11: Proprietary Technology Valuation Under the Cost Approach

$ millions

Technology Element	RCN	Obsolescence Factor	Notes	Adjusted RCN
Business Unit Website	$960	90.0%	(1)	$96
Inspection Review and Management System	1,080	33.0%	(2)	724
Customer Service Center	265	62.0%	(3)	101
Webservices:				
SBU to Oracle Financials	30	62.0%	(3)	11
Policy Data Conversion	6	62.0%	(3)	2
Document Issuance	60	90.0%	(1)	6
Modeling Data Transformation	60	62.0%	(3)	23
Data Streaming Application	30	62.0%	(3)	11
Data Warehouse	480	62.0%	(3)	182
Business and Technical Requirements	2,360	62.0%	(3)	897
System Architecture and Implementation	340	62.0%	(3)	129
External Development Services	1,700	29.4%	(2,4)	1,200
Total	**$7,371**	**54.1%**		**$3,383**
Indicated Value (Rounded)				**$3,400**

Footnotes:

(1) Project is anticipated to be replaced within 12 months.

(2) Project has been completed within the last 12 months.

(3) Obsolescence is estimated based on total company accumulated depreciation as a percent of historical cost.

(4) Project inefficiencies estimated to have contributed to cost overruns of approximately $500,000.

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§2.11 2. Dealer Network (Distribution Channel)

A company can reach its end users through direct and indirect channels. The direct sales model typically relies on a company's salaried sales professionals, while the indirect channel relies on external third parties, including sales representatives, dealers, vendors, distributors, and value-added resellers (VARs). Value can be attributed to these indirect channels because they may require substantial time, effort, and cost to establish.

EXAMPLE: XYZ reaches its customers through an indirect channel, which is comprised of a collection of 500 independent dealers that serve as VARs for the company's products. XYZ's "dealer network" was established over several years through the company's efforts to evaluate relevant market areas, identify appropriate dealers, negotiate exclusive distribution and other service agreements, and train new dealers on XYZ's products and procedures. In addition to being an integral component of XYZ's sales strategy, the dealer network provides a national "footprint" that may be valuable to third parties seeking to quickly establish a domestic distribution channel.

The total labor-related costs for the XYZ personnel involved in the development of the dealer network are estimated based on hourly salaries and the number of hours necessary to perform each task. As shown in Figure 12, the labor-related costs total approximately $2300 per dealer. As legal and other external costs are also required, including travel-related expenses, these amounts are estimated and included in the derivation of the total cost required to re-create each dealer in the network. Multiplying the total costs per dealer by XYZ's 500 dealers results in a value of approximately $1.9 million for the dealer network.

Figure 12: Dealer Network Valuation Under the Cost Approach

	Requirements			
Task	**Executive**	**Sales Mgr.**	**Finance**	**Total**
Hours Required:				
Evaluate Market Area	1	6	10	17
Identify Dealer Candidates	1	8	4	13
Negotiate Contracts and Agreements	2	6	0	8
Conduct Initial Training Program	0	16	0	16
Total Labor Hours per Dealer	4	36	14	54
Hourly Rate	$64.90	$43.27	$31.25	$41.76
Total Labor-Related Costs per Dealer	$260	$1,558	$438	$2,255
Legal and Other External Costs per Dealer				1,500
Total Costs per Dealer				$3,755
Number of Dealers				500
INDICATED VALUE (ROUNDED)				**$1,880,000**

Footnotes:

Annual Fully Burdened Salaries

Executive	$135,000
Sales Manager	90,000
Finance	65,000

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§2.12 C. Income Approach

The income approach focuses on the income-generating capacity of an asset. This approach is particularly useful in the valuation of intellectual property assets, because the most common forms of intellectual property contribute to a company's future income and cash flow. Trademarks, trade names, and brand names may contribute to future revenue by generating positive feelings in consumers' minds that influence their decision to buy a company's products and services. Design patents protect the ornamental and cosmetic appearance of products, which, if unique and aligned with consumer preferences, can be an important factor driving future product sales. Utility patents generally protect the way products function or how they are produced. Like design patents, a utility patent may provide unique advantages over competing products, which may result in incremental market share, revenue, and profit. A utility patent might also safeguard a unique manufacturing process that allows the owner to enjoy a higher profit margin compared to the competition. A contract with a key customer that secures future product sales would be directly related to the production of future revenue and cash flow for the owner of the contract.

The income approach is necessarily dependent on expectations of the future. Therefore, valuation of IP assets under this approach requires three fundamental elements:

- Development of financial projections;
- Estimation of the duration of economic benefit (or useful life); and
- Assessment of risk.

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§2.13 1. Development of Financial Projections

Because most intellectual property assets are analyzed and valued within the context of the businesses in which they are employed, developing financial projections for IP assets resembles the method utilized for an operating business. The primary variables generally include projected revenue, costs of goods sold, operating expenses, taxes, and other cash flow adjustments. The level of detail for the assumptions underlying these primary variables depends on the nature of the business or asset being analyzed, the complexity of the entity's operation, the degree of sophistication of the preparer, and the scope of the assignment for which the projections will be used.

Financial projections can be developed using top-down or bottom-up assumptions. Although the level of detail employed in each can vary, the top-down approach generally takes into account aggregate revenue growth rates and margins, while the bottom-up method generally relies on estimates of unit volumes, average selling prices, unit costs, and headcount requirements, among other factors. Consideration is also typically given to an analysis of fixed versus variable costs when projections are developed from a bottom-up perspective. From either standpoint, reasonable assumptions are generally developed based on analysis of company-specific historical trends and experience, comparisons to competitors or other market participants, and expectations for future supply, demand, and other economic factors.

Projected balance sheet items that impact cash flow, such as depreciation, fixed asset requirements, and working capital accounts, are typically estimated based on their relationship to revenue or other income statement figures. For example, projected fixed asset requirements (and the resulting capital expenditures) are typically estimated as a function of revenue, specifically the fixed asset turnover ratio, which measures the amount of revenue generated from investment in fixed assets. Similarly, working capital accounts such as receivables, inventory, and payables are normally estimated based on related turnover (or activity) ratios. However estimated, the projected balance sheet accounts should correspond to the assumptions used to develop the projected income statement data.

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.14 2. Estimation of Duration of Economic Benefit (or Useful Life)

§2.14 2. Estimation of Duration of Economic Benefit (or Useful Life)

The duration-of-income approach should reflect the economic life of the intellectual property asset, not necessarily its legal (or statutory) life. In the case of a utility patent, for example, the IP owner receives legal protection for a period of 20 years from the date of the application filing. See 35 USC §154(a)(2). Similarly, a noncompete agreement may provide the company with protection from competition for the period of time stipulated in the contract, typically 2 or 3 years. A license agreement to use a trademark might have a contractual term of 10 years. Although the legal duration of the IP asset should be taken into account, the IP asset's economic life may be longer or shorter. A license agreement may include provisions that allow the licensee to extend the contract beyond its stipulated term, thereby increasing its economic life. Conversely, a utility patent may become obsolete before its expiration due to technological advances, which would serve to curtail its economic life.

The means of estimating the economic life varies based on the type of IP asset, but generally includes a combination of quantitative analysis and qualitative reasoning. The quantitative frameworks tend to focus on analyzing rates of asset decay, attrition, turnover, or similar metrics. The qualitative approaches tend to focus on assessing the factors underlying the causes of such asset erosion. These factors commonly include functional and economic obsolescence, including the effect of technological advances, competition, legislative developments, changes in industry conditions, and other supply and demand factors.

Advances in form or style may also affect the economic life of certain IP assets, particularly trademarks and trade names. A trademark owner may update the look, style, or design of a trademark as a means to reposition or add strength to the brand. Figure 13 provides an example of how The Coca-Cola Company has changed certain marks of its flagship product since inception.

Figure 13: Coca-Cola Product Slogan

Date	Slogan
1886	"Drink Coca-Cola"
1904	"Delicious and Refreshing"
1923	"Enjoy Thirst"
1929	"The Pause that Refreshes"
1939	"Thirst Asks Nothing More"
1949	"Along the Highway to Anywhere"
1959	"Be Really Refreshed"
1969	"It's the Real Thing"
1979	"Have a Coke and a Smile"
1982	"Coke is It!"
1993	"Always Coca-Cola"
2000	"Coca-Cola…Real"
2006	"The Coke Side of Life"
2007	"Live on the Coke Side of Life"
2008	"Open Happiness"

The economic life of a trademark and trade name can also be influenced by "event" obsolescence, which refers to the deterioration in value caused by business transactions or events that are outside of the course of normal trademark activities. Mergers and acquisitions, divestitures and spin-offs, and corporate reorganizations serve as common forms of event obsolescence. In fact, a survey conducted by Enterprise IG, a global brand and identity consulting firm, found that no fewer than 3893 corporations around the world adopted new names during the year 2000 alone. In the United States, Citibank and Travellers Group combined to form Citigroup, Bell Atlantic and GTE merged to become Verizon; Pharmacia & Upjohn became Pharmacia; U.S. West was merged into Qwest Communications International; MCI

WorldCom became WorldCom; Warner Lambert was merged into Pfizer; Dayton-Hudson International assumed the name of Target Corporation; and Andersen Consulting became Accenture. In the Enterprise IG study, approximately 50 percent of the name changes in 2000 were done within the context of a merger or acquisition. In some recent transactions, even well known trademarks and trade names acquired were abandoned completely, as happened in Wells Fargo's acquisition of Wachovia, Bank of America's purchase of Countrywide, and JPMorgan Chase's acquisition of Bear Stearns.

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.15 3. Assessment of Risk

§2.15 3. Assessment of Risk

Once financial projections are developed over the expected useful life of the intellectual property asset, a discount rate must be selected to discount the future cash flows to their present value. The discount rate is intended to reflect all risks of ownership and the uncertainty of realizing the stream of projected future cash flows. It can also be interpreted as the rate of return that would be required by providers of capital to the company to compensate them for the time value of their money, as well as the risk inherent in the particular investment. Thus, the discount rate is also referred to as the "required rate of return." The selection of the appropriate discount rate is a critical assumption of the income approach because indicated values can vary greatly with only small changes to the rate.

While several models exist to develop discount rates for companies in aggregate, including the capital asset pricing model (CAPM), arbitrage pricing theory (APT), and various "build-up" methods, no commonly used models exist for the development of discount rates for specific IP assets. As a result, most valuation specialists triangulate on the appropriate IP discount rates by considering other required rates of return as proxies, assessing qualitative factors and characteristics of the subject IP asset, and performing other "reasonableness checks."

As mentioned previously, operating companies are a collection of tangible and intangible assets. A company's assets can be viewed as a hierarchy of risk, that is, cash is the lowest risk asset and goodwill (*i.e.,* unidentified intangible asset value) is typically the highest risk asset. Because commonly used models can be employed to estimate a discount rate for a company's assets in their entirety, derivation of a company-wide discount rate is typically the first step in selecting a discount rate for an IP asset. As a discussion of the various discount rate models is outside the scope of this chapter, assume that the company-wide discount rate is approximately 15 percent, which was derived through the CAPM model and the following assumptions:

Figure 14: Company-Wide Discount Rate Derivation

Capital Component	Capital Structure	Rate of Return	Weighted Return
Cost of equity capital	75.0%	18.0%	13.5%
Cost of debt capital (after-tax)	25.0%	5.7%	1.4%
Total	100.0%		14.9%

After deriving the company-wide required rate of return, discount rates are then selected for the company's various asset categories such that the weighted sum of the asset-specific discount rates approximates the company-wide discount rate. Rates of return for tangible assets typically consider rates observed in the capital markets, because lenders will commonly charge a premium over a reference rate (*i.e.,* LIBOR or prime) for companies seeking to finance their working capital needs (*i.e.,* receivables and inventory) and leverage their machinery and equipment assets. Although exceptions exist, the discount rates selected for IP assets are typically at or above the company-wide required rate of return, which reflects their intangible nature and generally higher risk profile. As shown in Figure 15, backlog is considered to have a risk profile slightly below the company overall, as the contractual characteristics and short duration of this asset lower its degree of risk. The discount rates selected for the company's other intangible assets give consideration to the nature of the assets, their presumed economic longevity and variability in expected cash flows, among other factors.

Figure 15: Hierarchy of Asset Risk and Required Returns

Weighted Average Return on Assets

$ thousands Tangible Assets	Indicated Value	Percent of Total	Company-Wide Required Return	Asset Premium/ (Discount)	Asset-Specific Required Return	Weighted Return on Assets
Cash and Cash Equivalents[1]	$5,000	3.3%			1.0%	0.0%

Net Working Capital (Excluding Cash) [2]	$13,500	9.0%			1.6%	0.1%
Machinery and Equipment Assets [3]	$27,500	18.3%			3.2%	0.6%
Intangible Assets and Goodwill						
Backlog	$3,000	2.0%	15.0%	-1.0%	14.0%	0.3%
Non-Compete Agreements	7,500	5.0%	15.0%	0.0%	15.0%	0.8%
Customer List	4,500	3.0%	15.0%	1.0%	16.0%	0.5%
Patents	14,500	9.7%	15.0%	1.5%	16.5%	1.6%
Trademarks and Trade Names	21,000	14.0%	15.0%	2.0%	17.0%	2.4%
Goodwill	53,500	35.7%			24.6%	8.8%
Total Intangible Assets and Goodwill	$104,000	69.3%				14.2%
TOTAL [4]	**$150,000**	**100.0%**				**15.0%**

(1) Return is based on a Libor rate of 1.7% on an after-tax basis.

(2) Defined as current assets minus current liabilities. Return is based on a Libor rate of 5.1% plus a 1.0% premium on an after-tax basis.

(3) Return is based on a prime rate of 7.8% plus a 2.0% premium on an after-tax basis.

(4) Assumes a total company enterprise value of $150 million.

It should be noted that discount rates selected for the intangible assets tend to more closely mirror the cost of equity capital for the company, as equity capital tends to warrant a higher rate of return due to its greater risk profile relative to debt capital. Moreover, discount rates for intangible assets of very early stage companies, or for IP assets that are considered very high risk, tend to resemble venture capital rates of return. Studies conducted by Plummer (see Plummer, QED Report on Venture Capital Financial Analysis (Palo Alto: QED Research, Inc., 1987)) and Scherlis and Sahlm (see Scherlis & Sahlman, A Method for Valuing High-Risk, Long Term, Investments: The Venture Capital Method (Boston: Harvard Business School Publishing, 1987)) are two sources of venture capital rates of return often cited by valuation specialists. The results of the studies are similar, showing that rates of return for start-up companies range from 50 percent to 70 percent, whereas rates of return for late-stage companies range from 20 percent to 35 percent.

While the company in Figure 15 is not a high technology company, the rate of return implied for the company's goodwill is calculated to be 24.6 percent. Goodwill, having an unidentifiable asset value, would typically possess the highest required rate of return. It is important to note that the rate of return for goodwill is *calculated* and not *selected,* as the goodwill dollar amount and rate of return are residual figures derived after values and rates of return have been estimated for the company's other assets. The 24.6-percent implied rate of return for goodwill would be assessed for reasonableness by observing its premium relative to the company-wide required return, the cost of equity capital, and, most importantly, the amount by which the rate exceeds those selected for the other identified intangible assets. The assessment would also consider the similarity of the goodwill rate of return to those required for venture capital investments.

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§2.16 4. Valuation Methods Under Income Approach

There are several methods available under the income approach to quantify the value of intellectual property assets. Some of the more common methods include the following:

- Relief-from-royalty method (see §§2.17-2.20);
- Lost profits (with and without) method (see §2.21);
- Greenfield method (see §2.22); and
- Excess earnings method (see §2.23).

Each of these methods has the same objective—to determine the amount of economic benefit directly associated with the subject IP asset over its economic life. The economic life of an asset generally refers to the period during which it is profitable to use that asset. In the case of a license agreement to utilize a patent, for example, it is relatively easy to observe the economic benefit directly attributable to the subject IP asset by virtue of contractual royalty payments. Other instances are not as straightforward, however, particularly when an IP asset is commingled with the general business operations or other IP assets. These instances require an "attribution analysis" to isolate the economic benefit of the subject IP asset under analysis, and can include such questions as:

- How much of the product's revenue is attributable to its trade name?
- How much of the project's cost savings is attributable to its patented process?
- How much of the company's total sales and marketing expense relates to acquiring new customers?
- How much of the company's projected revenue is attributable to its backlog and its existing customer base?
- How much protection in the value of the company does the noncompete agreement provide?

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§2.17 a. Relief-From-Royalty Method

The relief-from-royalty method is based on the assumption that, in lieu of ownership of an intellectual property asset, a company would be willing to pay a royalty in order to enjoy the benefits of the asset. Under this method, value is estimated by discounting the hypothetical royalty payments to their present value over the economic life of the IP asset.

The relief-from-royalty method is one of the most commonly used techniques to value IP assets. The high frequency of use is mainly due to the fact that the method is intuitive and requires relatively few assumptions, particularly the royalty rate, projected revenue, and discount rate. However, the shortcoming of the model is that the indicated value is highly dependent on the critical assumptions discussed in §§2.18-2.20.

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§2.18 (1) Royalty Rate

The selected royalty rate is typically developed through an analysis of comparable licensing agreements, which may involve third parties or the subject company itself in the event it has been a licensor or licensee of comparable intellectual property. With respect to third party transactions, RoyaltyStat (http://www.royaltystat.com/) and RoyaltySource (http://www.royaltysource.com/) are two subscription databases of royalty rates and license agreements, compiled from the U.S. Securities and Exchange Commission (SEC) EDGAR archive documents and other public sources. Transactions in these databases can be screened across various criteria, including licensor, licensee, industry, territory covered, form of agreement, and effective date, among others. Care should be taken to ascertain the comparability of such third party data to the subject IP, particularly with respect to whether the third party license agreements provide for exclusive or non-exclusive use of the IP asset.

In addition to company-specific and third party transactions, a reasonable range of royalty rates can be determined through an analysis of the profitability of the subject company using the IP asset. Valuation specialists often cite the rule of thumb that a potential licensee should be willing to pay a royalty ranging from 25 percent to 33 percent of its earnings before interest and taxes (EBIT) margin for an important IP asset. EBIT is typically used as a benchmark because it represents the profit that a company is able to generate from its operations and is unaffected by its capital structure. While this suggested range is as rough an approximation as any rule of thumb, the conceptual framework has intuitive appeal. That is, the royalty that a licensee should be *willing* to pay should take into account what the licensee is *able* to pay. Simplistically, if the licensee has an operating margin of 5 percent before the royalty payment, it would be unreasonable to assume that the licensee should be willing to pay a royalty of 7 percent of sales to use the IP asset. Doing so would result in an operating margin of negative 2 percent, all else being equal. In addition to profit margins, the royalty rate selected for valuation purposes should also reflect relevant qualitative factors, including the degree of importance of the IP asset to product sales, the contribution of the IP asset relative to other tangible and intangible assets owned by the company, consumer purchasing patterns and decision-making processes, and other factors.

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§2.19 (2) Projected Revenue

The royalty payment is typically expressed as a function of revenue. Within the relief-from-royalty method, revenue projections must be developed for the subject intellectual property asset over the duration of its economic life. Care should be taken to ensure that the projected revenues are consistent with the royalty rate data in terms of gross or net sales, and are reasonable when compared to historical sales trends, projected supply and demand factors, known or anticipated competitive behaviors, and other indicators.

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.20 (3) Discount Rate

§2.20 (3) Discount Rate

As mentioned previously, the selected discount rate should reflect the nature and characteristics of the intellectual property asset, including the assumed economic life and variability in expected cash flows, as well as the company-wide required rate of return.

EXAMPLE: ABC Corporation owns an important patent that is used in the production of heating and refrigeration equipment. Company management believes that the patent provides for manufacturing cost savings of 15 percent to 20 percent compared to comparable products of its competitors. The patent is expected to be viable for the next several years, at which point the industry is expected to complete its shift to the use of an alternative technology. As a result, the portion of ABC's products that utilize the patent is expected to decline over time. ABC has not licensed the patent to third parties, nor has it licensed similar technologies from others. Relevant royalty rates were obtained from various public company filings and other sources to serve as a basis for selecting an appropriate royalty rate for ABC's patent. Figure 16 provides a summary of the key licensing agreements identified in the valuation.

Figure 16: Third Party Patent License Agreements

	Royalty Rate	
License Agreement Description	**Low**	**High**
Automotive air-conditioning parts	3.0%	3.0%
Commercial air conditioning and air-filtration products	2.0%	3.0%
MegaCool technology for air-conditioners	5.0%	5.0%
Compressor and accumulator dehydrator for automotive air-conditioner systems	3.0%	3.0%
Heat pump systems	5.0%	7.5%
Orbital vane compressors	5.0%	8.0%
Rotary air handling machine	0.5%	5.0%

Based on a review of the third party royalty data and an assessment of the characteristics of the company's patent, a royalty rate of 4 percent is selected for the valuation of ABC's patent. General and administrative (G&A) expenses are deducted from the estimated royalty income to account for the costs necessary to administer and protect the IP, including necessary legal fees. After-tax cash flows are calculated by deducting G&A and tax expenses (based on a 40-percent tax rate) from the estimated royalty income stream. As shown in Figure 17, the after-tax cash flows are then discounted to the present utilizing a discount rate of 18 percent, which results in a value of $170,000 for ABC's patent.

Figure 17: Patent Valuation Under the Relief from Royalty Method

$ thousands		**For the Years Ending December 31,**					
		2007	**2008**	**2009**	**2010**	**2011**	**2012**
Total Company Revenue		$7,500	$8,100	$8,708	$9,317	$9,923	$10,518
% of Revenue Attributable to Patent		30.0%	27.5%	25.0%	22.5%	20.0%	17.5%
Revenue Subject to Patent		$2,250	$2,228	$2,177	$2,096	$1,985	$1,841
Revenue Growth		—	8.0%	7.5%	7.0%	6.5%	6.0%
Royalty Revenue	4.0%	90	89	87	84	79	74

Less: G&A Expenses		10	10	10	10	10	10
Operating Profit before Taxes		80	79	77	74	69	64
Less: Tax Expense	40.0%	32	32	31	30	28	25
After-Tax Cash Flow		$48	$47	$46	$44	$42	$38
Time to Midpoint		0.50	1.50	2.50	3.50	4.50	5.50
Present Value Factor	18.0%	0.921	0.780	0.661	0.560	0.475	0.402
Present Value of Cash Flows		$44	$37	$31	$25	$20	$15
Indicated Value (Rounded)		**$170**					

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Source: Business Law/Intellectual Property in Business Transactions/2 Intellectual Property Valuation/§2.21 b. Lost Profits (With and Without) Method

§2.21 b. Lost Profits (With and Without) Method

The lost profits method, also referred to as the "with and without method," estimates the value of an intellectual property asset by quantifying the loss of economic profits under a hypothetical condition when only the subject IP asset does not exist and needs to be re-created.

- The "with" scenario typically reflects the projections of the company under its existing business plan, which assumes that the IP asset exists and is able to be exploited by the company.
- The "without" scenario reflects the expected "damage" to the company as evidenced by lower expected cash flow due to the hypothetical loss of the subject IP asset.

The projected revenues, operating expenses, and cash flows are calculated in each scenario, and the difference in the annual cash flows (*i.e.,* the lost profit) is then discounted to the present to derive an indication of value for the IP asset.

While the lost profits method can be useful in valuing customer relationships, distribution channels, and other assets, the method is most commonly used to value noncompete agreements. These agreements are often signed in a merger or acquisition as a means to protect the value acquired by the buyer. The signatories to most noncompete agreements typically possess knowledge of the target's business that could have a detrimental impact on the business in the event they were to leave and compete against the acquirer following the transaction. The noncompete agreement may have value in that it serves as an "insurance policy" for the acquirer to protect its investment.

EXAMPLE: The Chief Technology Officer (CTO) of Target LLC, a software development company, signed a noncompete agreement in connection with ABC Corp.'s purchase of Target. The noncompete agreement contains terms and provisions reasonable and customary for such agreements, and precludes the CTO from engaging in competitive activities for a period of 2 years from the closing date of the acquisition.

The "with" scenario is based on the forecast developed by ABC during its due diligence. As shown in Figure 18, Target is anticipated to experience strong growth in revenue and margins over the 5-year projection period.

Figure 18: Non-compete Agreement - WITH Scenario

$ thousands		**For the Years Ending December 31,**					
		2007	**2008**	**2009**	**2010**	**2011**	**2012**
Total Company Revenue		$5,000	$6,000	$7,200	$8,600	$10,300	$12,400
Costs of Goods Sold		500	600	720	860	1,030	1,240
Gross Profit		4,500	5,400	6,480	7,740	9,270	11,160
Gross Margin		*90.0%*	*90.0%*	*90.0%*	*90.0%*	*90.0%*	*90.0%*
Operating Expenses		3,250	3,840	4,536	5,332	6,283	7,440
Operating Income		1,250	1,560	1,944	2,408	2,987	3,720
Operating Margin		*25.0%*	*26.0%*	*27.0%*	*28.0%*	*29.0%*	*30.0%*
Less: Income Taxes	40.0%	(500)	(624)	(778)	(963)	(1,195)	(1,488)
Add: Depreciation and Amortization	0.5%	25	30	36	43	52	62
Less: Capital Expenditures	0.8%	(38)	(45)	(54)	(65)	(77)	(93)
Add / (Less): Change in							

Working Capital	5.0%	(250)	(300)	(360)	(430)	(515)	(620)
After-Tax Cash Flow		**$488**	**$621**	**$788**	**$993**	**$1,251**	**$1,581**

The "without" scenario reflects changes to expected revenue, costs, and cash flows in the event the CTO were to leave ABC, form a new company, and compete against ABC. As the CTO is critical to the future success of ABC following the transaction, the loss of the CTO is estimated to have a severely negative impact on ABC for the next several years. As shown in Figure 19, management estimates that nearly 25 percent of the company's revenue would be lost in the first year of the hypothetical competition scenario. In addition, operating margins would be 3 percent lower as ABC would be compelled to implement new selling and marketing programs to mitigate the competitive threat. ABC management believes that it would take the company roughly 5 years to recapture the lost market share and return to profit levels estimated in its original business plan.

Figure 19: Non-Compete Agreement - WITHOUT Scenario

$ thousands		**For the Years Ending December 31,**					
		2007	**2008**	**2009**	**2010**	**2011**	**2012**
Total Company Revenue, WITH Scenario		$5,000	$6,000	$7,200	$8,600	$10,300	$12,400
% of Revenue Lost to Competition		*25.0%*	*25.0%*	*15.0%*	*10.0%*	*5.0%*	*0.0%*
Total Company Revenue, WITHOUT Scenario		$3,750	$4,500	$6,120	$7,740	$9,785	$12,400
Costs of Goods Sold		375	450	612	774	979	1,240
Gross Profit		3,375	4,050	5,508	6,966	8,807	11,160
Gross Margin		*90.0%*	*90.0%*	*90.0%*	*90.0%*	*90.0%*	*90.0%*
Operating Expenses		2,550	3,015	4,039	5,031	6,262	7,440
Operating Income		825	1,035	1,469	1,935	2,544	3,720
Operating Margin		*22.0%*	*23.0%*	*24.0%*	*25.0%*	*26.0%*	*30.0%*
Less: Income Taxes	40.0%	(330)	(414)	(588)	(774)	(1,018)	(1,488)
Add: Depreciation & Amortization		25	30	36	43	52	62
Less: Capital Expenditures		(38)	(45)	(54)	(65)	(77)	(93)
Add / (Less): Change in Working Capital	5.0%	(188)	(225)	(306)	(387)	(489)	(620)
After-Tax Cash Flow		**$295**	**$381**	**$557**	**$753**	**$1,011**	**$1,581**

The difference between the after-tax cash flows of the "with" and "without" scenarios results in the cash flows attributable to the noncompete agreement, which are discounted to the present utilizing a discount rate of 15 percent. As ABC management believes future competition to be unlikely, a probability factor of 25 percent is applied to the unadjusted value to derive a final value of $200,000 for the noncompete agreement.

Figure 20: Non-Compete Agreement Valuation Under the WITH and WITHOUT Method

$ thousands	**For the Years Ending December 31,**					
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
WITH Scenario After-Tax Cash Flow	$488	$621	$788	$993	$1,251	$1,581
WITHOUT Scenario After-Tax Cash Flow	295	381	557	753	1,011	1,581

Difference in Cash Flow		$193	$240	$231	$241	$240	$0
Time to Midpoint		0.50	1.50	2.50	3.50	4.50	5.50
Present Value Factor	15.0%	0.933	0.811	0.705	0.613	0.533	0.464
Present Value of Cash Flows		$180	$195	$163	$148	$128	$0
Total Present Value of Cash Flows		$813					
Probability of Competition	25.0%	$203					
Indicated Value (Rounded)		**$200**					

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§2.22 c. Greenfield Method

The Greenfield method first surfaced in the U.S. Tax Court case, *Jefferson-Pilot Corp. v Commissioner*, in connection with the valuation of an FCC license. See *Jefferson-Pilot Corp. v Commissioner* (1992) 98 TC 435, 454, aff'd 995 F.2d 530 (4th Cir 1993). The Greenfield method estimates the value of an intellectual property asset by quantifying the projected cash flows of a hypothetical startup company whose only holding is the subject IP asset. The valuation analysis resembles a traditional discounted cash flow (DCF) method for an entire company. It includes all necessary costs and expenses to build the company's infrastructure during the startup period, projected revenue and cash flows once the infrastructure is completed, and an estimate of the terminal value of the company at the end of the projection period.

The terminal value in the DCF method typically represents a significant portion of the value of a company, particularly a hypothetical start-up entity. There are two basic methods of computing the terminal value. One is the "multiple method," which uses a projected market multiple such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The other common method of computing the terminal value is referred to as the "perpetuity method," which uses the projected free cash flow as its basis, rather than EBITDA. The free cash flow projected in the final period is adjusted to arrive at a level of cash flow for the first year beyond the projection period that is representative of the future cash-generating capability of the hypothetical startup company. This "normalized" cash flow figure incorporates expectations of the level of investment required to maintain the business into the future, as well as the return on investment that the business can be expected to sustain. The normalized cash flow figure is then capitalized as a perpetuity by the selected discount rate, adjusted for a level of growth that can be expected into perpetuity.

While the Greenfield method is typically utilized to value FCC licenses, it can also be used to value other IP assets that might possess similar characteristics, including those that possess a high degree of scarcity and are a fundamental requirement for the operations of the subject company.

EXAMPLE: ABC Station, Inc., a radio station that serves the El Paso, Texas area, has valued its FCC license under the Greenfield method. Management estimates that the company would require roughly 1 year of investment before it is able to generate revenue, during which time it would lease office space, hire employees, perform market research, formulate its programming strategy, sign new customers and acquire furniture and fixture assets. After the first year, ABC management anticipates that it will be able to gradually gain market share, grow revenue, and improve its profitability. As ABC was formed approximately 5 years ago, management considered the company's actual experience in developing reasonable estimates for the hypothetical startup scenario, adjusted for current market conditions. The terminal value of ABC is estimated under the perpetuity method assuming a 5-percent long-term growth rate and a 20-percent discount rate. As shown in Figure 21, the indicated value of ABC's FCC license is $5 million.



Figure 21: FCC License Valuation Under the Greenfield Method

$ thousands		For the Years Ending December 31,						Terminal Value[(1)]
		2007	2008	2009	2010	2011	2012	
Total Revenue		$0	$500	$2,000	$5,000	$8,500	$12,000	
Cost of Sales		0	200	750	1,750	2,763	3,600	
Selling & Marketing Expenses		100	300	750	1,500	2,300	2,750	
General & Administrative Expenses		300	650	725	1,000	1,500	2,100	
Operating Profit before Taxes		($400)	($650)	($225)	$750	$1,938	$3,550	
% of Revenue		--	*-130.0%*	*-11.3%*	*15.0%*	*22.8%*	*29.6%*	
Tax Expense	40.0%	0	0	0	0	565	1,420	
Operating Profit after Taxes		($400)	($650)	($225)	$750	$1,373	$2,130	
Add: Depreciation & Amortization		0	85	120	160	200	240	
Less: Capital Expenditures		(350)	(250)	(250)	(250)	(250)	(250)	
Add / (Less): Change in Working Capital		0	(13)	(50)	(125)	(213)	(300)	
After-Tax Cash Flow		($750)	($828)	($405)	$535	$1,110	$1,820	
Time to Midpoint		0.50	1.00	2.00	3.00	4.00	5.00	
Present Value Factor	20.0%	0.913	0.833	0.694	0.579	0.482	0.402	
Present Value of Cash Flows		($685)	($690)	($281)	$310	$535	$731	$5,120
Indicated Value (Rounded)		**$5,000**						

(1) Terminal value calculation via perpetuity method:

2013 Cash Flow	$1,911
Gordon Growth Rate	5.0%
Terminal Value	$12,740
Present Value Factor	0.402
Present Value of Terminal Value	$5,120

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§2.23 d. Excess Earnings Method

While the relief from royalty method can be characterized as a *direct* means of estimating the economic cash flow generated by an intellectual property asset by virtue of the royalty rate, the excess earnings method can be characterized as an *indirect* technique of quantifying similar cash flows.

Specifically, the excess earnings method estimates the value of an IP asset by quantifying the amount of residual (or excess) cash flows generated by the IP asset, and discounting those cash flows to the present. On the surface, the method substantially resembles a "traditional" financial projection for a company, which includes revenues, costs of goods sold, operating expenses, and taxes projected for the next several years based on reasonable assumptions. Unlike a traditional financial projection, however, the excess earnings methodology requires the application of contributory asset charges, which are also referred to as "economic rents."

Conceptually, in order for an IP asset to have economic value, the IP asset must generate sufficient cash flow to replace and/or provide a fair return to the owners of other assets that contribute to its generation of future cash flow. These charges represent the return *on* and *of* all contributory assets, and are applied in order to estimate the true "excess" earnings generated by the IP asset. Contributory asset charges typically include payments for the use of working capital, tangible assets, and other intangible assets.

The application of contributory asset charges also serves to eliminate overlap in cash flow that could potentially overstate the value of the subject IP asset. For example, consider the case of a software development company that sells a well-known customer relationship management application. In using the excess earnings methodology to value the company's proprietary software technology, a contributory asset charge related to the trade name would be deducted from the software technology's operating income to give recognition to the contribution the trade name makes to the end-user license sales. The omission of the trade name charge would overstate the cash flow generated from the proprietary software technology and therefore overstate its value.

Although different methodologies exist, contributory asset charges are typically calculated based on the indicated value of an asset and its required rate of return. The charges are usually quantified in dollar terms and then expressed as a function of revenue on a normalized basis.

The excess earnings method is typically used to derive the value of a filmed entertainment library because the method lends itself to specific consideration of the unique characteristics of the asset, including the strength and overall quality of the titles, historical financial performance, and future ability to license titles and generate income.

EXAMPLE: An investment group is considering the acquisition of XYZ Company, which owns, among other assets, a 1000-title library comprised of international distribution rights to theatrically released feature films, television series, television movies, and documentaries. The distribution rights vary among titles in both length and medium (*i.e.,* theatrical, video, pay television, and free television). The investment group requires a third party appraisal of the XYZ library as a basis for negotiations and has retained a qualified valuation specialist to provide a recommendation of value.

The primary challenge in valuing the XYZ library is forecasting future cash flows, which requires the following considerations:

Content. The forecasting methodology employed typically depends on the number of properties in the library. In addition, the quality and format of content (*e.g.,* feature films, television series) must be considered because the ability to re-license top box office feature films is much greater than that for low budget documentaries. As discussed in this section, a by-title approach was used to forecast cash flows from XYZ's Evergreen feature films while a by-territory methodology was used for the remaining titles.

Licensing rights. Financial projections cannot be developed without a detailed understanding of the rights owned. The XYZ library consists of titles with distribution rights for a limited term, in a single territory for a specific medium, as well as titles with global rights for all media in perpetuity. As the XYZ titles are licensed to third parties under various agreements, a detailed review and analysis of XYZ's availabilities was also undertaken.

Financial. XYZ's gross cash flow projections were developed based on a comprehensive review of historical licensing activity for each title, territory, and medium. In addition, distribution, residuals, and participation costs

were forecast after an analysis of historical trends and contractual obligations.

As discussed, XYZ's financial projections were developed using both by-title and by-territory methodologies. As the name implies, a by-title approach is a bottom-up analysis considering each title on an individual basis. Future cash flows were estimated for all media across key territories after giving consideration to each title's historical sales and future availabilities. Evergreen properties were forecast under the by-title approach to account for their high market demand and expected longevity. A by-territory approach was employed for the remaining XYZ titles. Although considered, a by-title approach was not employed because such methodology typically results in aggressive forecasts for lower quality product. Moreover, a large rights library typically has more programming hours available than demanded by the marketplace.

For purposes of the by-territory approach, titles were grouped based on format and quality rating. Characteristics considered when determining quality ratings included United States box office performance, talent, genre, MPAA rating, awards, and total revenue earned. The by-territory approach considered XYZ's historical and planned distribution strategy. An analysis of licensing history within each group of titles identified (1) the number of titles licensed each year, (2) average license fees, and (3) average term of each license (each a "representative level"). The analysis identifies the historical demand for each group across all territories and forms the basis for projected demand.

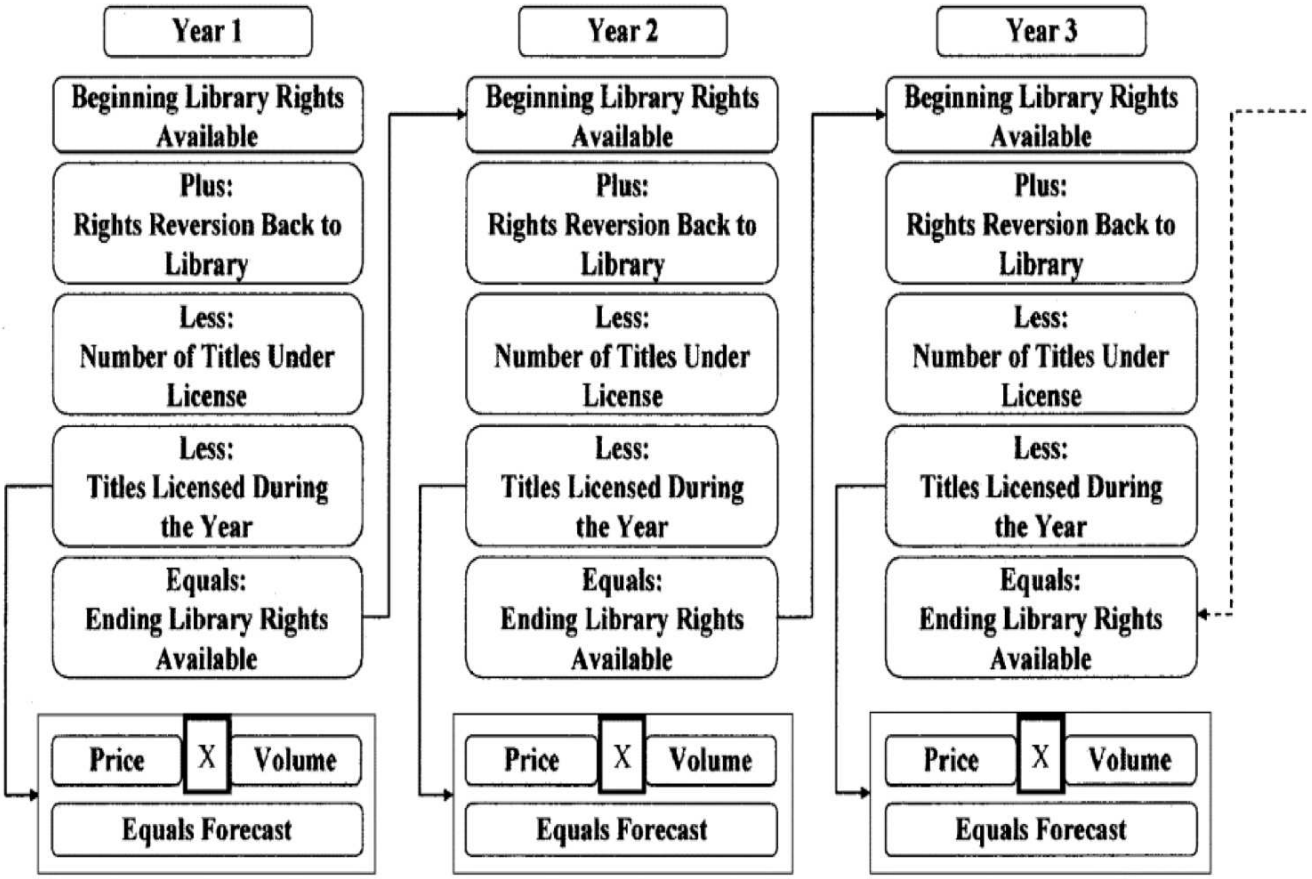
An availabilities model was then created to determine the number of titles within each group that are available to be licensed each year. The analysis considered the following factors:

- The number of titles available to be licensed at the beginning of the projection period;
- Titles that have been previously licensed with distribution rights reverting back to the library owner during the projection period;
- Titles with distribution rights expiring during the projection period;
- Titles that are licensed for a future broadcast date (licensing agreements are often entered into many years before the actual television broadcast date); and
- Reversion of distribution rights back to the library owner for projected "new" sales based on predetermined representative levels (the average term of the license).

XYZ gross cash flows were projected by multiplying the average license fee (price) by the average number of titles sold per year (volume). Figure 22 illustrates the steps used to forecast the XYZ library using a by-territory methodology.



Figure 22: By-Territory Gross Cash Flow Forecast Methodology



Distribution, residual, and participation costs, which were estimated as a percent of gross cash flows, were deducted to derive pretax cash flows. Although contributory asset charges are not typically included in the valuation of a film library under the excess earnings method, certain charges were considered appropriate in the case of the XYZ library. Specifically, charges for the use of tangible assets and XYZ's well-recognized trademark were deducted from the library gross cash flows. A working capital charge was not deducted as the projected cash flows were prepared on a cash basis.

After-tax cash flows were calculated by deducting tax expense from projected pretax cash flows. As shown in Figure 23, the after-tax cash flows were then discounted to the present utilizing a discount rate of 12 percent, which results in a value of $147 million for the XYZ library.

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Figure 23: Film Library Valuation Under the Excess Earnings Method

$ millions		For the Years Ending December 31,					Terminal Value [1]
		2007	2008	2009	2010	2011	
Gross Cash Flow							
By-Title		$ 27,855	$ 26,433	$ 23,455	$ 19,865	$ 15,032	
By-Territory		41,282	37,154	33,438	30,095	27,085	
Total Gross Cash Flow		$ 69,137	$ 63,587	$ 56,893	$ 49,960	$ 42,117	
Less:							
Distribution Costs		5,185	4,769	4,267	3,747	3,159	
Residuals & Participations		6,914	6,359	5,689	4,996	4,212	
Trademark Charge	2.0%	1,383	1,272	1,138	999	842	
Tangible Asset Charge	0.5%	346	318	284	250	211	
Pre-Tax Cash Flow		$ 55,310	$ 50,869	$ 45,515	$ 39,968	$ 33,694	
Less: Tax Expense	40.0%	22,124	20,348	18,206	15,987	13,477	
After-Tax Cash Flow		$ 33,186	$ 30,522	$27,309	$ 23,981	$ 20,216	
Time to Midpoint		0.50	1.50	2.50	3.50	4.50	
Present Value Factor	12.0%	0.945	0.844	0.753	0.673	0.601	
Present Value of Cash Flows		$ 31,358	$ 25,750	$ 20,571	$ 16,129	$ 12,140	$ 40,739
Indicated Value (Rounded)		**$147,000**					

(1) Terminal value calculation via perpetuity method:

2011 Cash Flow	$ 11,533
Gordon Growth Rate	-5.0%
Terminal Value	$ 67,841
Present Value Factor	0.601
Present Value of Terminal Value	$ 40,739

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§2.24 IV. CONCLUSION

Intellectual property assets have a prominent role in determining the health and future productivity of the global economy. They have become critical success factors for various types of businesses and often serve as the primary means of differentiation in a progressively competitive marketplace. Lenders and other capital providers recognize the importance of IP assets to a company's strategy and seek innovative financing solutions that allow borrowers to leverage their IP portfolios in ways previously unattainable.

While fundamental valuation approaches remain the same, the specific methods and techniques used to quantify the value of IP assets are constantly evolving in response to the increasing prominence of IP and the need for more accurate measurements. The methods require the use of numerous assumptions, involve the assessment of several quantitative and qualitative variables, and unequivocally rely on the professional judgment and experience of the valuation specialist. Understanding the means by which the value of IP assets can be estimated is of critical importance to numerous constituencies that seek to develop, exploit, rely on, or critique such values.

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3

Structuring Transactions Involving Intellectual Property

Ralph M. Pais
Hank F. Dempsey

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§3.1 I. INTRODUCTION

This chapter provides an overview of the major types of deal structures for business transactions involving intellectual property (IP).

Why might transactions involving IP assets be different from other business transactions? In many respects, IP and non-IP transactions have a great deal in common. Both involve the familiar issue of how to define with sufficient precision the terms and conditions by which the parties will buy, sell, or otherwise commercially exploit an asset. Indeed, some IP transactions need not be treated differently. For example, companies can easily purchase common retail software through fairly standard nonexclusive end-user license agreements. Nevertheless, the presence of IP in a transaction can raise a number of different and novel considerations when structuring a transaction, compared with a transaction involving tangible assets.

This chapter is intended to assist counsel in understanding the ways in which the presence of intellectual property as a core component of a company's business can influence transaction structure. It is also intended to help counsel spot major potential IP issues in a transactional context.

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§3.2 II. LAWYER'S ROLE

In practice, IP-oriented transactions can be quite complex. Some transactions will require the counsel of a mergers and acquisitions (M&A) specialist in conjunction with IP counsel, tax counsel, contracts experts, and export specialists experienced in the subject area. The inherent dangers to a company in an IP-focused deal are not minor, nor are they always obvious. The best way to minimize risks and give the client's proposed transaction the greatest possible chance of success is to obtain experienced, specialized legal advice early in the process.

Depending on the client's stage of development (assuming it is a business entity), lawyers may play a significant role in providing advice on potential transactions related to the client's intellectual property early in the company's life. Transactions completed at the beginning of a company's existence may have a significant impact on its long-term development. Hence, it is customary to involve the company's regular corporate counsel as well as IP counsel when considering the best approach to a proposed transaction. For larger companies planning to engage in exclusive licensing or other collaborative relationships, it will often be important to secure the assistance of skilled antitrust counsel to assure that the transaction will not trigger antitrust problems. Finally, it is critical to consider the tax implications of any proposed transaction, which will be a major influence on the ultimate deal structure. The lesson here is that IP deals often require an experienced and diverse legal team, in contrast to more straightforward asset acquisitions.

For example, when the contemplated transaction is a merger or complete acquisition, a team of lawyers will be needed for each party. Typically, in addition to the corporate, IP, and tax lawyers, M&A transactions may also involve litigators to evaluate any pending or threatened litigation, and employment and benefits lawyers to evaluate executive compensation and benefits packages. If the target company has significant operational facilities, real estate and environmental lawyers may be needed to evaluate whether unseen but potentially enormous liabilities could unintentionally accompany the targeted assets. While many transactions, especially smaller ones, can be ably handled among corporate, tax, and IP counsel, it is not unusual for larger M&A transactions to require the services of half a dozen attorneys or more. Such a rogue's gallery may not be necessary in each case, but it is wise to consider what depth of expertise will be necessary at the outset of every IP-oriented transaction.

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§3.3 III. TYPES OF INTELLECTUAL PROPERTY; SPECIAL CONSIDERATIONS

The transactions discussed in this chapter involve one or more of the major forms of intellectual property in the United States—patents, copyrights, trade secrets, and trademarks. Each type of IP has different legal rights associated with it, and it is important to understand the nature of those rights before advising a client with respect to any proposed transaction. Different types of IP will raise different considerations. Sections 3.4-3.8 summarize key aspects of each type of intellectual property and note special deal considerations that may apply to each.

It is particularly important for the parties in an IP-related transaction to be clear about *ownership* of the intellectual property rights that are the subject of the transaction and to ensure that ownership is *documented* in detail. See generally §1.12. The potential for uncertainty and confusion over the precise boundary of property rights in IP is a frequent source of problems in structuring transactions. The level of clarity in ownership will significantly influence the conduct of due diligence, valuation, drafting of contract terms, and other aspects of the deal. As discussed more fully in chap 8, transfers of ownership of patents, copyrights, and trademarks must be accomplished by written instrument. Any assignment or bill of sale should describe the rights transferred with specificity, and should be recorded in the appropriate federal office.

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§3.4 A. Patents

The strongest form of intellectual property protection available, a patent gives the holder the power to exclude others from making, using, or selling any product that infringes the claims of the patent. See 35 USC §271(a). Patents cover any novel, useful, and nonobvious process, machine, manufacture, or composition of matter (see 35 USC §101), and generally last 20 years from the date an application was filed with the U.S. Patent and Trademark Office (see 35 USC §154). Patents can also be secured for genetically modified plants and ornamental designs. See 35 USC §§161, 171.

Patents allow the holder to bring suit for infringement (see 35 USC §281), to recover damages (often in the form of reasonable royalties (see 35 USC §284)), and potentially to enjoin the sale of infringing products (see 35 USC §283). A valid patent can also defeat or bar independent discovery, because patent infringement need not be willful or intentional to be actionable. See 35 USC §§271(a), 273(b)(1), 282. This means that developers must be aware of the prior art (see 35 USC §§103(a), 301) during their research and development or else risk creating something that infringes an existing patent. The search for prior art can be complex, in part because the prior art may not be well known or easily identified. However, if the developer obtains a valid patent that improves or relies on one or more other patents to produce a certain outcome or product, the developer will still require a license from the holder of the other patents in order to fully utilize the new invention.

For a more comprehensive discussion of patent law, see Chisum, Chisum on Patents: A Treatise on the Law of Patentability, Validity and Infringement (2007).

SPECIAL CONSIDERATIONS: Because of the dangers of infringement, proper IP due diligence is very important when acquiring a patent portfolio for use. Patent due diligence is discussed more fully in chap 4, but suffice it to say that counsel could spend a potentially infinite amount of time researching third party patents and prior art, leaving the attorney to determine the threshold level of acceptable risk. Further, in negotiations involving patent applications, owners should utilize confidentiality agreements to protect their not-yet-patented trade secrets in case the deal is not consummated. For a sample form of such a confidentiality agreement, see §§8.2-8.3. The parties should also be aware that patent protection must be secured on a country-by-country basis, although procedures under the Paris Convention for the Protection of Industrial Property of March 20, 1883, as amended (available at http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html) and the Patent Cooperation Treaty of June 19, 1970, as amended (available at http://www.wipo.int/pct/en/texts/articles/atoc.htm) facilitate this process. Finally, the parties should be aware that willful patent infringement exposes the infringing party to the risk of treble damages. See 35 USC §284.

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Source: Business Law/Intellectual Property in Business Transactions/3 Structuring Transactions Involving Intellectual Property/§3.5 B. Copyrights

§3.5 B. Copyrights

Copyright protects original works of authorship (such as literary works, musical compositions, sound recordings, plays, artwork, photographs, motion pictures and other audiovisual works, and even computer software) as soon as they are fixed in a tangible medium of expression. 17 USC §102(a). Although not required for basic copyright protection, registration with the U.S. Copyright Office is a prerequisite to bringing an action for copyright infringement (and recovering statutory damages or other remedies). See 17 USC §§411-412. A copyright grants the holder certain exclusive statutory rights, including the rights to control the reproduction, sale, licensing, and distribution of the copyrighted work, to create derivative works, and to bar others from doing the same for a term of at least 70 years. See 17 USC §§106, 302(a). Subsequent works can infringe a copyrighted work by copying it whole or in part, or otherwise violating the copyright owner's exclusive rights in the work, although independent creation is not barred. See 17 USC §§106, 501(a). So-called "fair use" of a copyrighted work does not constitute infringement (see 17 USC §107), and purchasers of lawful copies have limited rights under the "first sale" doctrine (see 17 USC §109(a)). For a more comprehensive discussion of copyright law, see Nimmer, Nimmer on Copyright: A Treatise on the Law of Literary, Musical and Artistic Property, and the Protection of Ideas (1963).

Ownership of copyrighted material becomes complex if the work has been produced by a group of collaborators or by one or more independent contractors, because each contributor is a co-owner of the copyright to the work. See 17 USC §§103(b), 201(a). Work produced by employees is deemed a "work for hire" and is owned by the employer (see 17 USC §201(b)), but independent contractors normally retain the copyright to their work unless they have agreed otherwise. It is therefore *very important* for companies using independent contractors in development of their products to enter into written agreements under which the contractors assign all their right, title, and interest in the works being created to the company retaining them. For a sample form of independent contractor agreement, see §8.17. For further discussion and another sample independent contractor agreement form, see Advising California Employers and Employees, chap 3 (Cal CEB 2005).

Use of contractors is a common practice for early stage companies, and counsel should be sure to provide such clients with appropriate forms of agreement to use with their independent contractors. The issue becomes even more difficult if the company elects to use contractors located outside of the United States. In that case, counsel should obtain advice from local counsel to ensure that the forms of agreement used will be effective and enforceable in the jurisdiction where the contractor resides and is performing the services.

SPECIAL CONSIDERATIONS: Questions regarding the boundaries of ownership of copyrighted works, including the documents establishing ownership, should always be a key focus of due diligence. Due diligence investigations of intellectual property rights, including copyright, are discussed in chap 4.

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§3.6 C. Trademarks

Trademarks are subject to both federal and state law. See, *e.g.,* 15 USC §§1051-1129; Bus & P C §§14200-14272. In general, a trademark (or service mark) is a word, name, or symbol that that allows a manufacturer or merchant to identify and distinguish its goods or services from others in commerce and to indicate the source of the goods or services. See 15 USC §1127. Federal trademark law also protects trade dress and trade names. See 15 USC §§1125, 1127. The right to a trademark or service mark is established through continuous use in commerce. See 15 USC §1051(d). Although registration is not required, trademarks and service marks should be registered with the U.S. Patent & Trademark Office to provide notice of use to third parties, to evidence an exclusive right to use the mark, and to entitle the registrant to sue for trademark infringement. See 15 USC §§1072, 1114-1115. The strength and defensibility of a mark depend in part on its distinctiveness and the lack of any secondary meaning. See 15 USC §1052. The principal test of trademark infringement is the likelihood of confusion (see 15 USC §1114(1)). Suits may also be brought to prevent dilution of a famous mark by blurring or tarnishment (see 15 USC §1125(c)), as well as to prevent use of counterfeit marks and other violations (see 15 USC §§1114(1), 1116(d)). Both damages and injunctive relief are available under federal law. See 15 USC §§1114(2), 1116-1118. For a more comprehensive discussion of trademark law, see McCarthy, McCarthy on Trademarks and Unfair Competition (4th ed 1992).

SPECIAL CONSIDERATIONS: Trademarks are not assignable unless the assignment includes the goodwill of the business with which the mark is associated. 15 USC §1060(a). Any assignment of a registered mark must be recorded in the U.S. Patent and Trademark Office to afford constructive notice to bona fide purchasers for value. See 15 USC §1060(a)(3), (4). For further information and sample trademark assignment forms, see §§8.8-8.10. Trademark protection is also available under the laws of other nations, but the level of protection available for a particular mark may vary widely depending on the jurisdiction. See generally Watts, *International Trademark Protection: An Overview of the Options*, 22 CEB Cal Bus L Prac 1 (Winter 2007). Trademarks in use internationally therefore present special challenges in due diligence, with respect to both ownership and infringement liability.

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§3.7 D. Trade Secrets

Generally, a trade secret is information (such as a formula, process, technique, pattern, compilation, design, drawing, or specification) that has independent economic value because it is not generally known to others and is subject to reasonable efforts to maintain its secrecy. CC §3426.1(d). Trade secrets are commercially valuable because they give their owners an economic advantage over potential competitors. One well-known example is the formula for the COCA-COLA® soft drink. See §1.15. Insufficient efforts to maintain secrecy, inadvertent disclosure by the company, independent development, or reverse engineering of the trade secret may all compromise the right. Remedies for trade secret misappropriation include injunctions and damages in the form of lost profits or a reasonable royalty. CC §3426.3. Trade secrets are protected from misappropriation under state law (see generally CC §§3426-3426.11), and there is generally no registration requirement. For a more comprehensive discussion of trade secret law, see Trade Secrets Practice in California (2d ed Cal CEB 1996); Milgrim, Milgrim on Trade Secrets (LexisNexis 2007).

SPECIAL CONSIDERATIONS: Because maintaining secrecy is critical to legal protection of trade secrets, vigorous ongoing efforts to maintain confidentiality and protect against disclosure are essential. These efforts may include implementation of company policies on information restrictions and trade secret protection; nondisclosure agreements with current and departing employees and anyone else given access to the information; physical security of company facilities, documents, and files; and the use of firewalls and encryption for electronically stored data. The methods used by a target company for protection of its trade secrets are another important aspect of due diligence. See generally chap 4.

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§3.8 E. Computer Software

The intellectual property in software can be protected under copyright, patent (in the United States, but not necessarily outside of the United States), or trade secret law, but software itself is not a separate type of intellectual property right. Software does not fit precisely under any one IP rubric, both because it is a relatively recent technological development and because it shares characteristics with traditional copyright and patent subjects. In a sense, software is a "written machine."

Under copyright law, only the literal code and certain nonliteral elements of a computer program are protectable. Ideas, processes, utilitarian or stock elements, command hierarchies, and public domain elements are not protectable. Because copyrighted works cannot be infringed by independent creations, many sophisticated software developers now use "clean rooms" to produce software that can be verified as independent from preexisting software while offering substantially the same functionality. Reverse engineering of software to enable compatibility is generally considered fair use. See 17 USC §1201(f).

Under U.S. patent law, software can be protected more broadly as a process or apparatus patent. See 17 USC §101; *AT&T Corp. v Excel Communications, Inc*. (Fed Cir 1999) 172 F3d 1352, cert denied (1999) 528 US 946, abrogated on other grounds in *In re Bilski* (Fed Cir 2008) 545 F3d 943, 960 n19. This approach has the value of being more precise as well as more protective of the functional elements of the program, but the patent prosecution process is also more costly and demanding, in part because of the burden of researching the prior art. See §§3.4, 4.21-4.22.

Most software is made available for use in binary, object-code form that has been compiled from an underlying source-code form of the program. In addition to protecting their software by means of the copyright and patent laws, many creators of software protect the proprietary nature of their software by maintaining the source code as a trade secret. In other words, they provide their customers and users of their software the executable binary code version, but not the source materials, which will be kept secret. Without the source code, making changes to the object code will not be possible. Companies that adopt this approach seek to preserve the competitive value of their software by not making its design and inner workings available to others.

There are, however, an increasing number of companies that subscribe to one or another open source model and make their software available to others under the terms of an open source form of license agreement. In these models, the company has decided that the value of the software to the company's business is not dependent on maintaining the source code as a trade secret. The substantial challenge that such a model can raise is that introduction of open source code into otherwise "closed" trade secret code may "taint" the protected code under the terms of the applicable open source license terms and compel disclosure of source code that the company wishes to maintain as a trade secret. As a result of this possibility, it is essential that counsel fully investigate and understand precisely how any computer software relevant to the transaction is protected. For further discussion of open source issues, see §§8.31-8.32. See also Murray, *Open Source: A Challenge Worth Meeting*, 24 CEB Cal Bus L Prac 105 (Fall 2009).

SPECIAL CONSIDERATIONS: Because the legal protection of rights in software can vary widely, proper due diligence is essential to clarifying ownership of the rights as well as the potential exposure to liability for infringement. A single piece of software may have involved many creators who contributed to its development. It is therefore important to confirm that licenses have been secured for all software portions created by third parties and that ownership rights have been assigned for all work done by contractors and employees within the company.

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Source: Business Law/Intellectual Property in Business Transactions/3 Structuring Transactions Involving Intellectual Property/§3.9 IV. KEY DIFFERENCES BETWEEN INTELLECTUAL PROPERTY AND TANGIBLE ASSETS

§3.9 IV. KEY DIFFERENCES BETWEEN INTELLECTUAL PROPERTY AND TANGIBLE ASSETS

Intellectual property is distinguishable from more traditional tangible assets (land, buildings, machinery) and financial assets (cash, investments, accounts receivable, and inventories) in four important ways that affect how a transaction might be structured:

- IP valuation is more difficult;
- IP ownership is more uncertain;
- IP is nonrivalrous and less easily restricted; and
- IP law can convey the power of exclusion.

These distinctions are reviewed in §§3.10-3.13.

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§3.10 A. IP Valuation Is More Difficult

Intellectual property is notoriously difficult to value accurately. The high technology and life sciences markets are constantly in flux, with new technologies, companies, and business models constantly entering and exiting the market. The intellectual properties underlying these companies are often bought, sold, or licensed on the mere *possibility* that they *might* be useful or profitable years into the future. Such a forward-looking approach to investment means that IP-focused companies are often acquired earlier in their business cycle than other companies. This also means that investments in research and development (R&D) play a key role in development of useful intellectual property and the success or failure of the company that owns it.

This uncertainty makes pricing an intellectual property portfolio far more challenging than valuing a piece of land or a production facility with a more predictable market value. Because the value of intellectual property can be volatile, to the benefit or detriment of the owner, transactions must be structured with this uncertainty in mind so as to protect potential upside rewards and minimize downside risks for the client.

Valuation of intellectual property is discussed in detail in chap 2.

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§3.11 B. IP Ownership Is More Uncertain

Ownership of intellectual property is often more uncertain than ownership of tangible assets, particularly when the creators of the IP (or employers of the creators) have not taken good care from the outset to document their ownership rights properly. A lack of attention to the issue of ownership during creation can lead to unforeseen disputes months or years later when a potential owner begins due diligence as part of a proposed transaction. For example, preexisting prior art, nontransferable licenses, unassigned work of former contractors or employees, and jointly produced creations are all common sources of ownership disputes. Ownership issues are also a predictable problem in collaborations and partial asset acquisitions.

Resolving these ambiguities later on may be difficult if the people who contributed to the creation of the IP either cannot be easily found or attempt to use their newly discovered rights to extract concessions from the parties to the present transaction. This danger is especially pronounced when license agreements or joint ventures lead to the creation of new IP. Ownership between the parties and the rights to future use should be properly addressed in advance in the relevant documents, to avoid potential later uncertainties.

As a practical matter, counsel should encourage clients who plan to produce (or are already producing) IP to start the "paper trail" as soon as possible. The first and most important step is to ensure that all employees and independent contractors have signed well-drafted confidentiality and invention assignment agreements. See §§6.37-6.40, 8.15-8.17. In addition, if the company is one in which there may be inventive work being conducted by the employees, it is prudent to counsel companies to adopt an invention disclosure policy that encourages, and perhaps provides financial incentives for, employees to make timely disclosure of any inventions that could be worth considering for patent protection. See generally §§1.19-1.23. Such policies can be motivational to employees as well as preventing possibly valuable new inventions worth patenting from going unreported due to the press of day-to-day work. Furthermore, the company should document any third party intellectual property that is incorporated into a product at any stage of development and ensure that the company has necessary licenses to the third party IP. In general, the company should also create and maintain detailed records of its software development, patent-related experiments, and other R&D activities. See §1.19.

Failure to adequately document ownership or to ensure that IP is properly conveyed by its creators (whether employees or independent contractors) to legal owners creates uncertainty—thereby increasing the risks associated with ownership and impairing the value of the IP. Waiting too long to do so may result in disputes among co-producers over IP rights or even complete preemption by third parties who have documented their inventions first. Even individual inventors or "garage partnerships" should not wait until the founding of their company to start documenting their efforts.

Uncertainty of ownership can lead to expensive and protracted litigation and even disrupted operations. The 2006 RIM/NTP patent dispute that threatened to shut down BlackBerry service across the U.S. (see Krazit & Broache, *BlackBerry saved* (CNET.com, Mar. 3, 2006), available at http://www.news.com/BlackBerry-saved/2100-1047_3-6045880.html) is but one example of how misjudgments about ownership (whether innocent or calculated) may have huge practical implications.

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§3.12 C. IP Is Nonrivalrous and Less Easily Restricted

As an intangible asset, intellectual property is generally considered "nonrivalrous." This means that it can be used or consumed by one party without precluding its simultaneous use by another party, unlike tangible assets such as land, raw materials, or manufactured products. This also means that the knowledge represented by an IP right is often scalable (and profitable) at a speed and scope that tangible assets cannot match.

Conversely, the lack of physical limitations on the use of IP also means that competitors can more easily infringe or misappropriate IP, especially in foreign countries where effective legal protections may not be available. As a result, security measures ranging from voluntary restrictions on proprietary information to encryption and trade secret protection will be important to protecting the value of the asset.

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§3.13 D. IP Law Can Convey Power of Exclusion

Although each type of intellectual property right has unique legal attributes (see generally §§3.4-3.8), the owners of IP in the United States and certain other countries all enjoy the ability to exercise certain exclusive legal rights over their IP and to prevent others from infringing on those rights. This limited form of monopoly power allows IP owners to control unique products and services that otherwise could be easily copied and sold by competitors. For example, a valid patent can keep a competitor's independently invented and developed—but inadvertently infringing—technology off the market. Products protected by IP laws can provide returns far in excess of commodity products sold in mature markets with lower barriers to entry. This limited monopoly power can also be used offensively, perhaps to bar competitors from selling a potentially competing product or to extract a valuable licensing agreement.

EXAMPLE: Imagine that a startup company intends to develop a new form of medical device that would provide a less invasive and less costly means of conducting a certain type of medical examination. The founders of the company are also the inventors of the technology, which their university plans to patent and license back exclusively to the founders' new company. In connection with a venture capital financing, prospective new investors begin their IP diligence and discover a reference in the technical literature to a similar medical device. Research reveals that the founders' invention, which is core to their business plan, was anticipated by a prior invention in a different country, and this fact raises an absolute bar to the university's ability to obtain the requested patent and renders worthless the license that was the foundation of the company's IP. The once-promising venture is no longer economically viable and will likely fail because it cannot secure a patent to exclude other companies from later copying its product.

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V. MOTIVATIONS FOR IP-RELATED TRANSACTIONS

§3.14 A. Growth, Synergy, and Speed

There are a number of motivations that can lead a company to pursue an IP-focused transaction and to seek another interested company as a counter-party. All companies wish to improve profitability and long-term value, and there are many means by which companies pursue these goals. Among the motives that drive intellectual property-oriented transactions, the most common are a company's desire for growth, synergy, and speed, discussed in §§3.15-3.17.

Together, growth, synergy, and speed—if realized—can provide a substantial competitive advantage to a company, and this is why many technology companies rely heavily on licenses, collaborations, acquisitions, and mergers to drive the creation of value.

EXAMPLE: An intellectual property license or collaboration between a small tech company and a larger established company permits both entities to pursue all three goals. The small company can grow its profit stream and its market reach by relying on the established company's production and distribution chain to get its innovation to market more quickly. Similarly, the larger company extends its own reach and profitability by putting more innovative products on the market without large and unpredictable investments in R&D. Alternatively, the parties' respective goals may be more effectively reached through a purchase or sale of selected IP assets, or the complete acquisition (through a variety of means) of the smaller company by the larger.

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§3.15 1. Growth

All companies naturally seek to grow, but intellectual property-related transactions can enable a company to compete in profitable new markets far more efficiently than if the company invented the IP from scratch. IP deals allow companies in existing markets or with existing lines of products to quickly improve or expand their offerings to increase market share and profitability. IP acquisitions can also provide access to preexisting customer bases or geographic markets, and even open the door to cross-selling opportunities where new products can be sold to existing customers. Some companies seek growth through consolidation of competing companies and products, thereby increasing their scale of operations and profitability (subject to antitrust restrictions). A business might also acquire IP as part of a vertical integration strategy to reduce production costs or manage supply risks. Conversely, a company may need certain IP rights to enter into a new market in order to diversify its product lines, especially if existing product lines are low margin commodities or certain IP rights are nearing expiration.

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§3.16 2. Synergy

Closely related to growth is synergy, which is the acquisition of complementary resources that together permit more efficient or innovative production. Put another way, synergy simply refers to any combination of intellectual property assets that yield more together than if held separately. When there is synergy among technologies, infrastructure, and R&D, companies can reap lower production costs through economies of scale, faster times to market, and even previously unattainable leaps in product capability. Unfortunately, synergy is difficult to forecast accurately, and overly optimistic projections of synergy can lead a company to overpay for an IP asset. In fact, overestimation of expected synergies is perhaps the single greatest reason for the failure of mergers and acquisitions to produce predicted returns.

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§3.17 3. Speed

If a company needs an intellectual property asset quickly, it is often much faster to purchase or license the asset than to create it anew or design around it (especially if the necessary IP is patented). As markets evolve and consumer tastes or industry requirements change, profitability windows will often shrink, making time to market a critical factor in the commercial success or failure of an innovation. IP transactions permit companies with an identified need to fill that need in the quickest manner possible.

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§3.18 B. Individual Motivations

Although many intellectual property-focused transactions are between companies seeking to advance their own growth strategies, sellers sometimes have more individual motivations for selling, sharing, or licensing their IP. Illiquidity is a frequent motivation for exiting a market (*i.e.,* the seller really needs the money). Alternately, a corporation may realize that an IP asset is outside of its core competency and may find managing the property to be more time-consuming and costly than profitable. An owner of an individual patent might find the right to be of little value because it is not part of a larger portfolio of related (and essential) IP. Personal reasons can also be a motivating factor. For example, an inventor, company president, or rights holder may be ill or wish to retire from business. Although fully understanding the seller's reasons for coming to the table may not be necessary for a buyer to finalize a worthwhile transaction, it can certainly be helpful in negotiations, particularly if it enables the parties to craft terms that address their most important needs.

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§3.19 C. Common Strategic Motivations

The following table sets forth some of the strategic objectives that motivate parties to acquire or dispose of intellectual property assets. It is not intended to be all-inclusive, but rather to suggest common motivations and thereby serve as a discussion framework for further conversations with clients.

Common Strategic Objectives for Intellectual Property Transactions

Reasons to Acquire or In-License IP	Reasons to Sell, Share, or Out-License IP
Acquire key technology allowing entry into a new market	Access to complementary products and markets
Eliminate a competitor and consolidate market position	Exit a low margin or unprofitable market space
Create synergies and long-term growth for founders, investors, and creditors	Create liquidity for founders, investors, and creditors
Access seller's customer base	Access acquirer's customer base
Faster and less expensive than development "from scratch"	Faster access to established production and distribution infrastructure
Expand or add a product line	Expand profitability of asset outside area of competition
Diversification of IP portfolio, which may be aging	Reverse overextension and focus on core competencies
Acquirer's stronger management would make IP more competitive and profitable	Poor management, causing assets to underperform
Prevent potentially expensive infringement claims	Insufficient funds or interest to prosecute potential infringement claims
Potential synergy between current portfolio and third party IP rights	Extract value from IP rights that are not being monetized
Gain a first-mover or time-to-market advantage	Avoid dilution and cost of building own infrastructure
	Personal reasons of owner(s) (*e.g.,* ill health, retirement, illiquidity)

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§3.20 VI. FIVE PHASES OF TRANSACTION

The structuring of an IP-focused acquisition, collaboration, or merger is only one step in the larger deal-making process. Before looking at transaction structures in detail, it is worth briefly reviewing the five basic phases in the lifecycle of most deals (particularly mergers and acquisitions):

(1) Strategic assessment (see §3.21);

(2) Structuring the transaction (see §3.22);

(3) Due diligence (see §3.23);

(4) Negotiation and drafting of terms (see §3.24); and

(5) Integration and monitoring (see §3.25).

Although joint ventures and licensing agreements do not necessarily follow precisely the same path, the major elements of the process are relevant to them as well.

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§3.21 A. Phase 1: Strategic Assessment

When considering a merger or acquisition, a buyer's first step will be to identify the strategic reasons why it would want to acquire some or all of another company's business instead of pursuing its strategic goals through more limited means. This will require an in-depth analysis not only of the target company, but also of other competitors and the market itself. Once a company understands what it needs and what the market can offer, it can formulate its strategic objectives and draw up a market plan to guide it toward that end.

After a market plan has been developed, potential targets or partners should be identified. Investment bankers are often retained to find suitable merger or acquisition partners, while joint ventures and license agreements are usually arranged by the companies themselves with the assistance of legal counsel.

Once a potential partner has been identified and approached, companies will often sign nondisclosure agreements and begin "business" diligence. Business diligence concerns the business case for a potential deal and examines data such as company financials, competitor intelligence, and sales and customer information.

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§3.22 B. Phase 2: Structuring the Transaction

As the business diligence phase progresses and the target assets come into clearer focus, if both parties remain interested in a deal, they can begin to determine the best way to structure the transaction in order to achieve their business goals (*e.g.,* as a license, a joint venture or collaboration, an acquisition of some or all of a target company's assets, or merger with the entire target company).

If satisfactory, one party will usually decide to make an offer to the other party in the form of a "term sheet" of key provisions, including a proposed deal structure and a recommended final deal price (or a method for calculating it). An illustrative term sheet for a collaboration agreement is presented in §3.61. The remainder of this chapter addresses a number of considerations for choosing an appropriate structure for the transaction.

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§3.23 C. Phase 3: Due Diligence

Once a term sheet is signed, legal due diligence begins. The due diligence phase is a highly detailed process of investigation, research, and analysis of the company and the relevant assets and liabilities using both publicly available and proprietary information protected by confidentiality agreements. Diligence helps the potential buyer better understand the target asset and the risks associated with it.

Proper diligence will verify the documentation of the assets, including their validity, ownership, liens, licenses, potential infringements, and other relevant factors. For intellectual property, the due diligence process will examine valuation and risk assessment, and confirm IP ownership. It will also closely investigate any contractual limitations, such as covenants not to compete, geographic or use restrictions, and exclusive out-licenses.

The main purpose of this step is to gain the greatest assurance possible that the acquirer's valuation and synergy assessments are accurate and that no major risks remain hidden. It is important to note that the diligence process can be lengthy and can overlap with the other phases. For example, transactions are often provisionally structured before diligence is complete, but the results of later diligence can lead to substantial changes in an already proposed deal structure. For a detailed discussion of intellectual property valuation, see chap 2. Due diligence investigations of intellectual property assets are discussed in detail in chap 4.

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§3.24 D. Phase 4: Negotiation and Drafting of Terms

Once a term sheet is in place and due diligence is underway, negotiation of detailed deal terms can begin. The negotiations will cover a wide variety of matters, including the specific rights bargained for, final price, supplemental licenses, representations and warranties of the assets, and source of financing. As noted in §3.23, information from the diligence process will still be coming in, and may lead the parties to request changes or other adjustments in the terms as necessary. Once the diligence process is complete, parties can finalize and sign the transaction documents.

Ultimately, the company holding the intellectual property rights should correct any defects in intellectual property ownership identified in the due diligence process so that the rights are as "clean" as possible before the transaction is completed and the rights change hands. For additional information on drafting IP-related transactional documents, see chap 5 on licensing, chap 6 on joint ventures and collaborations, chap 7 on intellectual property issues in M&A agreements, chap 8 on related documents, and chap 9 on secured lending transactions involving intellectual property.

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§3.25 E. Phase 5: Integration and Monitoring

Once a formal agreement is signed and the closing occurs, the last phase of the transaction is post-deal implementation, when consideration and assets change hands and both parties monitor use of the intellectual property assets to ensure that their agreement is followed correctly. This phase typically involves managing the intellectual property portfolio, auditing royalty reports, and policing infringement. It is also during this phase that the parties learn whether their expected synergies will materialize. Companies should use this time to periodically reassess their licenses and royalties, as well as any new market developments that might change the risks and the value created by the IP rights that were the subject of the transaction.

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§3.26 VII. PRIMARY TRANSACTION STRUCTURES

Companies seeking to create new products or to expand existing product lines inevitably face the "build-buy" dilemma: Is it better to manufacture what the company needs to grow, or should the company buy the technology (or key components of it) from someone else? And if a company decides that it is faster or less expensive to acquire a desired technology from another individual or company, the questions become more numerous and complex: How should the company acquire what it needs? Does it buy it outright from the owner? If so, what exactly will the company own, and can the company later sell all of it, or even part of it? Does the company share the technology with the owner? Does the company license it? Can the licensor sell it or lease it to someone else? Could a competitor do the same thing? And what happens if the company creates something new with acquired or licensed technology—will the company own that new creation and be able to exploit it?

The same set of considerations applies when a company has developed products or concepts that are not central to its core business strategy. How can the company realize the value of these creations while not allowing someone else to use them to compete against the company? How can the company retain sufficient rights for its own use and possible future needs while recouping its previous investment? The individual answers to these questions will shape the structure of the transaction and ultimately determine what the company does and does not own or control.

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§3.27 A. Desired Level of Control Guides Choice of Transaction Structure

At the simplest level, the questions in §3.26 all center on the issue of *how much control over the intellectual property rights the parties wish to have*. One easy way to think about the control question is to view the choice of a transaction structure as a function of two variables: (1) the extent of *ownership* and (2) the extent of *exclusivity* desired by the client.

How important is it for the company to *own* the intellectual property (meaning, to have all right, title, and interest in it), as opposed to licensing or sharing only certain necessary rights to the IP while allowing the current owner to retain title and the ability to exercise other particular rights? Ownership has two primary advantages: Not only does it provide a substantial level of control over the IP right, but the monetary value of that right is more easily transferred and monetized. Conversely, while a license might be less expensive, it might also not be assignable and therefore not resalable if the client later finds that the right is no longer useful. Ownership and use, however, are far more expensive and carry with them other liabilities, including the risk of infringement.

Furthermore, how important is it that the arrangement gives the company *exclusive* rights to prevent others (perhaps even the current owner) from using the IP rights or engaging in certain behaviors? Exclusivity is a major consideration in structuring a transaction because IP rights are usually valuable to others as well—leaving right-holders to balance the tension between monetizing a valuable right and protecting their competitive advantage. The optimal level of exclusivity will generally be determined by the threat level posed by potential competitors. Exclusivity will also be a greater concern in transactions where ownership of the IP rights are less clear cut, a situation often caused by the existence of multiple related licenses or joint ventures.

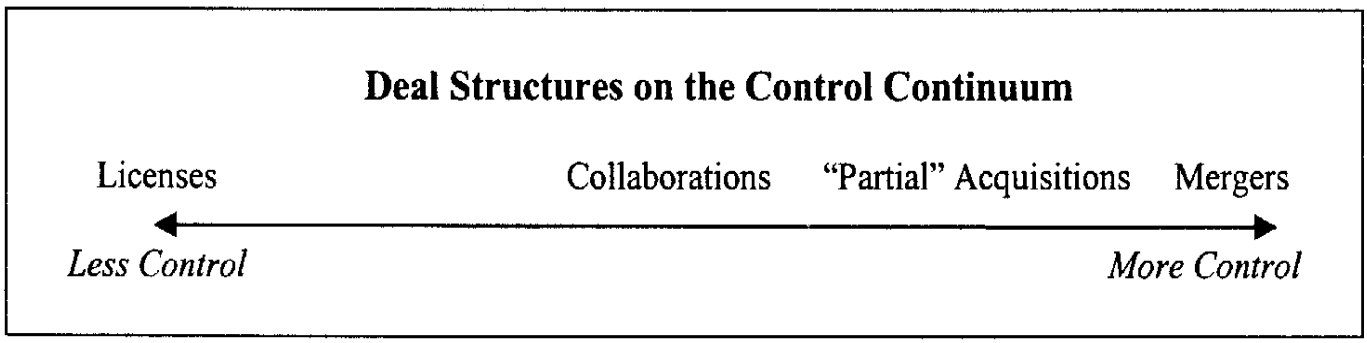
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§3.28 B. Four Possible Transaction Structures

Although there are many perspectives from which to approach the structuring of intellectual property-focused transactions, the four major structures can be described along a continuum ranging from less control to more control over the intellectual property rights that are the subject of the transaction:

- License agreements;
- Collaborations or strategic alliances (which are a variant of license agreements, and may include highly structured and complex joint ventures);
- Partial asset acquisitions (purchasing specific assets and liabilities of a company, but not the entire company itself);
- Mergers (or complete acquisitions) (when an entire corporate entity is merged with the acquirer, or all or substantially all of its assets are purchased by the acquirer).

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Each of these four structures provides the client with a greater or lesser degree of control over the desired IP right, with a merger or complete acquisition providing the strongest level of ownership and exclusivity. Joint ventures or collaboration agreements grant only partial control and varying degrees of exclusivity, while nonexclusive licenses offer the least amount of control. The relative strengths and applications of each of these four basic structures are examined in greater detail in §§3.29-3.47.

Of course, the optimal structure for a particular transaction will ultimately be influenced by a wide variety of factors, in addition to the target IP—the overall business needs and goals of the parties, the importance of ownership and exclusivity to those goals, the parties' ability to pay, and the tax consequences of different possible deal structures.

Because this chapter is intended simply to provide an overview of transaction structures, counsel should refer to the other chapters of this book for a more detailed understanding of each individual approach. Intellectual property licenses are the subject of chap 5, collaboration agreements (also known as strategic alliances) are discussed in chap 6, and merger and acquisition agreements are treated in chap 7. In particular, counsel should give careful consideration to the tax implications and consequences of each choice. Tax issues in IP-related transactions are discussed in chap 10. Tax consequences not only shape deal structure but obviously have a direct impact on transaction value. Counsel should be certain to consult with tax counsel before settling on any form of transaction or finalizing the key deal points.

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1. License Agreements

§3.29 a. Overview

A licensing arrangement is simply an agreement between two parties in which the owner of the intellectual property grants the licensee contractual permission to use IP in a manner that would otherwise infringe the licensor's ownership. Intellectual property licenses are usually limited in their scope (what IP may be used), territory (where the IP may be used), term (how long the IP may be used), and consideration (what the license is exchanged for).

License agreements are discussed in detail in chap 5. For purposes of this overview, it is important to recognize that although a nonexclusive license is the most limited form of IP control, it is also generally the fastest and least expensive means for a prospective licensee to acquire the rights that it needs to another party's intellectual property. If the intellectual property being licensed is central to the licensee's business, the company may wish to secure an exclusive license. An exclusive license would be more expensive, but it would also ensure the licensee that no other potential competitors could later obtain the same IP rights.

From the perspective of the licensor, a licensing arrangement may allow it to realize additional value from intellectual property that may be outside of its core business strategy or products. Licensing becomes a way to recover development costs and to generate revenue that can be used for other business activities.

Licenses also have their drawbacks. Without an explicit grant of exclusion and infringement rights in the license, the licensee may not be able to exclude third parties from using the IP right or to recover against those who infringe it. The flexibility of licenses can also be a weakness. With the increasing fragmentation of the technology market, the proliferation of IP licensing agreements can blur the boundaries of a company's IP portfolio: Which license rights are transferable? Which are divisible? Licenses are also not ideal for IP rights that are core to the client's business, because the lower degree of control may pose at least two problems. First, if the license is nonexclusive, a competitor could secure the same license from the licensor and undercut the first licensee's profitability. Second, the licensor could choose to terminate or not to renew the license, or perhaps even "hold up" the licensee by demanding exorbitant licensing fees once it becomes apparent how important the license is to the licensee's continuing business.

In determining whether a license agreement is the right structure for the client, the factors discussed in §§3.30-3.33 should be considered.

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§3.30 b. When License Agreements Are Advantageous

A license agreement may be advantageous in one or more of the following circumstances:

- **The IP is important, but is not core.** The intellectual property right is not central to the company's business but would still be useful, making ownership less necessary.
- **The IP is core, but an exclusive license is available.** The intellectual property right is core to the company's business, but the company can obtain exclusive rights to the IP through licensing.
- **The IP is not for sale.** The owner is not otherwise willing to sell the intellectual property asset, and the right is important to the prospective licensee.
- **A low-cost method to acquire use of the IP is desired.** A license is advantageous for a company that is financially risk-averse (or unsure of the ultimate value of the right) and wishes to gain access to the right for a low up-front investment. Payment for the intellectual property right can often be linked to the revenue generated from the licensee's use of the intellectual property.
- **The need for the IP is time-limited.** If the company only needs the intellectual property right for a short period of time, a license may be the most cost-effective alternative for obtaining it.
- **There are multiple potential licensees.** A license is a useful structure for an intellectual property owner if the owner has multiple potential licensees that can provide an ongoing revenue stream from the intellectual property.

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§3.31 c. Countervailing Considerations

In contrast, a license may not be advisable if one or more of the following conditions are present:

- **The license is not transferable.** The license may not be assignable to a buyer if the licensee is bought out, thereby lowering the value of the license. Reverse-triangular mergers are sometimes used to circumvent this problem, although the licensee agreement might still be terminated under a change of control clause (see §3.44).
- **There are too many restrictions.** Licenses may carry a number of restrictions, some of which could interfere with the company's product development or entry into new markets by restricting the use of the intellectual property to particular products or regions.
- **The license is short-term.** Licenses are usually time-limited, raising the possibility that the license may not be renewed or may be renewed only at a substantially increased rate, potentially disrupting the licensee's production or undercutting profitability.
- **The licensee must rely on the owner for enforcement.** Because patent and copyright law generally permit only the right holders to bring suit for infringement, absent explicit agreement to the contrary, a licensee will be reliant on the owner-licensor to police infringements of the licensed rights. This may be a problem if the licensor lacks sufficient funds or interest to prosecute potential infringements, or acts more slowly than the licensee would like.

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§3.32 d. Financial Considerations

Counsel should address the following financial issues in negotiating a license agreement:

- **Structure of license fees.** Payments under license agreements may consist of up-front license fees, running royalties, or some combination of both. Often, the more that the licensee is willing and able to pay as an up-front license fee, the lower the running royalties will be. However, a licensee may be unwilling to agree to high up-front payments if the value to the licensee's business of the licensed intellectual property is difficult to predict with certainty.
- **Calculation of royalties.** Royalty payments are often calculated as a percentage of net sales or net revenue (or perhaps as a fixed amount per unit); accordingly, the base number for making royalty calculations will be very important. Licenses may become fully paid (*i.e.*, no further royalties are due) after some period of time or after a certain royalty cap has been reached. In other instances, royalties will continue to be payable for as long as the licensee uses the licensed right. Counsel should be familiar with the range of royalty rates that are customary for the type of intellectual property being licensed, the scope of the rights being granted, and the particular industry. For further discussion of royalty issues, see §§5.16-5.28.
- **Audit rights.** From a licensor's perspective, it will be important to have periodic audit rights to ensure that the licensee is calculating the royalty amounts correctly and is paying all royalties due under the agreement, and is otherwise in compliance with the terms of the license agreement, especially any restrictions. See §§5.42-5.46.
- **Sublicensing.** If sublicensing is allowed, special consideration should be given to how royalties will be determined if the licensee sublicenses some or all of its rights to a third party. The licensor should take particular care not to create opportunities for the licensee to avoid or greatly reduce royalty obligations through "clever" sublicensing arrangements. Uncontrolled sublicensing can be quite risky from a licensor's perspective; at the same time, the licensee will want the flexibility of being able to sublicense as a means of reaching markets or other opportunities that it might not be able to pursue on its own. See §5.48.
- **Alternative forms of payment.** The consideration for a license need not always be financial. License agreements can be based on cross-licensing arrangements under which intellectual property rights are shared for a period of time. Some companies might even structure an in-kind exchange or barter agreement in which they trade a certain quantity of products or services in exchange for an intellectual property license.

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§3.33 e. Drafting Considerations

There are certain elements common to nearly all license arrangements, such as representations and warranties, and indemnity, assignability, confidentiality, and dispute resolution clauses. Licensing agreements, however, also have unique aspects where problems can arise and the dangers of a mistake are greatest. When drafting a licensing agreement, counsel should make sure to address the following questions:

- **What exactly is being licensed?** Patents? Copyrights? Trade secret information? A combination of rights? A limited subset of those rights? What about grant-backs for future developments?
- **Who is the licensee**? Does the license apply to the initial licensee only, or can the licensee sublicense, assign, sell, subdivide, or otherwise transfer the license to a third party? What about future partners? Is the license exclusive or does the licensor retain the right to license the right to other parties as well?
- **Are there limits on the license?** Is the right restricted to certain fields of use? Specific products? Specific services? Geographic areas? Specific markets?
- **What is the financial arrangement?** Is the license fee paid up front or through royalties? How are the royalties to be calculated? Per unit? By net or gross profit? Is there an opportunity for cross-licensing or other reciprocity?
- **Are there ongoing requirements?** Does the licensor retain any rights of inspection? Is the licensee required to periodically provide information on the use of the intellectual property right? Must the licensee achieve certain use or revenue milestones within a specified period?
- **What is the term of the license?** Does the license exist for the useful life of the IP itself? Does it have a fixed term? Could certain triggering events lead to the termination of the license?

For further discussion of drafting considerations in licensing transactions, see chap 5.

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2. Collaborations

§3.34 a. Overview

A collaboration is an agreement between two or more companies to work together in some way toward an agreed goal, while sharing assets, risks, and rewards. Collaborations can range in structure from a fairly simple cross-licensing or cooperation agreement between two companies to a formal joint venture involving the creation of a new legal entity. Joint ventures and collaboration agreements (also known as strategic alliances) are discussed further in chap 6.

In IP-centric collaborations, both parties will usually have preexisting intellectual property rights that each hopes to combine with the other's to create something new and valuable to both sides. One common example can be found in the biotech industry, where a company may have intellectual property rights in a particular chemical compound that could be developed into a valuable therapeutic product for a certain disease, but the company lacks sufficient expertise in developing therapeutics for that particular disease. In such a case, it may be advantageous for the IP owner to enter into a collaboration with another company experienced in that field. Although cooperation could also take the form of a straight licensing arrangement between the two companies, if both believe that the project has the potential to create substantial value, they may choose to collaborate and thereby share the risks and rewards of joint development.

To determine whether a collaboration agreement is the right structure for the client, the factors discussed in §§3.35-3.38 should be considered. See also §6.2. An illustrative term sheet for a collaboration agreement is presented in §3.61.

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§3.35 b. When Collaboration Agreements Are Advantageous

A collaboration agreement may be advantageous if one or more of the following circumstances apply:

- **Both synergies and risks are present.** Each party has valuable intellectual property, skills and expertise, R&D capabilities, or funding to contribute, but neither party is assured of success on its own.
- **Collaboration will enable faster time to market.** When cooperation reduces R&D time, a collaboration can substantially reduce time to market. This can expand an innovation's period of profitability, which may more than compensate the intellectual property owner for the profits shared with its partner.
- **The parties have complementary strengths.** The parties bring different expertise and strengths to the collaboration, *e.g.*, one has development expertise, while the other has manufacturing or marketing expertise.
- **The parties operate in complementary markets.** The parties do business in different markets or parts of the world and can leverage those differences to their mutual benefit.
- **There are heavy R&D requirements.** If making a technological leap requires heavy R&D spending but a profitable outcome is still uncertain, each party can bear the costs and risks more easily by sharing them, while simultaneously preserving the right to a substantial share of the profits from a successful innovation.

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§3.36 c. Countervailing Considerations

In contrast, a collaboration may not be advisable if one or more of the following issues poses a substantial problem:

- **Collaborations involve greater complexity.** The success of a collaboration is heavily reliant on a good working relationship between partners. Working with another autonomous partner with its own independent management, schedule, financing, procedures, and employees adds far more complexity to the relationship than if the relevant rights were simply purchased or licensed. The added complexity in turn requires greater time and attention from management and staff to keep things running smoothly.
- **Collaboration requires a well-defined relationship.** Because collaborations can blur otherwise clear boundaries between companies, potential collaborators should try to anticipate and address the major foreseeable conflicts in advance. Perhaps the single greatest issue facing collaborators is precisely how ownership of any jointly developed intellectual property will be shared. Other possible problems include the precise sharing of costs, responsibilities during development, individual use of the shared IP rights, the ability of either party to license or transfer its ownership interest, restrictions on the persons to whom that interest might be transferred, and the procedures for dispute resolution and termination of the collaboration. Careful advance planning is necessary to prevent later problems that could defeat the entire purpose of the collaboration.

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§3.37 d. Financial Considerations

Collaborations involve the sharing of the costs and rewards of an enterprise, which further increases the complexity of the deal. The financing of a collaboration is normally detailed by contract, but even this can be challenging because the method of allocating both costs and rewards of collaboration must be agreed on in advance. The inputs to a collaboration may vary widely, ranging from cash or other financing to in-kind contributions of materials, services, facilities, or intellectual property. Cost and benefit allocations can be fixed or may vary over time, depending on the particular needs of the parties. Sharing of the rewards can be structured as straight profit-sharing, royalty payments, or perhaps a simple cross-license permitting both companies to use independently the intellectual property developed through the collaboration.

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§3.38 e. Drafting Considerations

In addition to the drafting issues identified in §3.33 with respect to license agreements, collaborating parties should discuss the following issues when drafting their agreement:

- The value (both IP and other skills) that each party brings to the collaboration.
- What each party will allow the other to do with its IP.
- The scope of the collaboration. Will it cover research and development only? Will it include manufacturing and marketing? What about defense of the right in case of infringement?
- The parameters of the collaboration. What is each party responsible for doing?
- How will decisions be made?
- How will progress be assessed?
- Who will own new inventions created during the collaboration?
- How will conflicts be resolved?
- The parties' relative shares of costs, risks, and rewards:
- Who will pay for what?
- How will economic gains or losses be shared?

For further discussion of the issues involved in joint ventures and collaboration agreements (strategic alliances), see chap 6. See also the illustrative term sheet for a collaboration agreement in §3.61.

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3. Partial Asset Acquisitions or Sales

§3.39 a. Overview

There are situations where a company may wish to sell off a discrete part of its business or intellectual property portfolio. The property sold may consist of a particular division of a larger business, a discrete product line, or an individual product. In some instances, a company may wish to sell not only the intellectual property assets related to that part of its business, but all of the tangible assets (and associated liabilities) that are part of that division or product line. The mix of assets acquired along with intellectual property may include inventory, contracts associated with the line of business, facilities, and the seller's employees who work in the affected division or business unit. Conversely, a company may wish to acquire part of another company's business because of perceived synergies or profit opportunities in connection with its own business. In both cases, the transactions are usually structured as the purchase and sale of identified assets and liabilities.

From the purchaser's perspective, this approach is a good way to acquire a limited set of specific assets. From the seller's perspective, this is a good way to realize value from assets that may no longer be core to the seller's overall business or strategic direction. This approach may not be optimal for either party if the IP assets are used in more than one part of the seller's business and the seller will need the continuing right to use some or all of the very IP rights it wishes to sell in order to continue operating certain parts of its business. In such circumstances, the parties will need to determine whether the seller's continuing needs will impact the value the buyer is interested in acquiring and how the parties' respective interests can be achieved.

Unlike licenses and collaboration agreements, explored in §§3.29-3.38, asset acquisitions involve the actual transfer of title of the intellectual property assets, often with related tangible assets. Special care should be taken at the beginning of the transaction to confirm that the seller indeed has clear title to the IP rights. Intellectual property may be encumbered by license agreements or a lender's security interest, which would reduce the value of the asset being acquired. The seller will also need to consider carefully whether it currently uses, or might need to use in the future, any of the IP assets that it is selling. In such a case, the seller should consider simply licensing the IP, or selling but licensing it back from the buyer for a specified, limited use.

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§3.40 b. When Partial Asset Acquisitions or Sales Are Advantageous

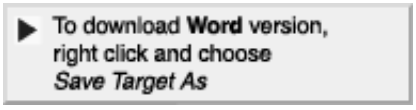
A partial asset acquisition may be advantageous in the following instances:

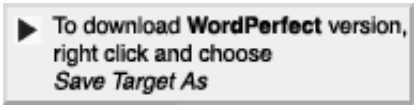
- **Only certain target assets needed**. If a buyer needs only part of another company's portfolio and wishes to purchase a discrete group of assets, then a partial acquisition may be ideal.
- **Right sizing**. A partial asset sale is ideal if a seller wishes to spin off or sell an identifiable piece of the company while retaining control of the remainder. A seller may also wish to sell certain assets that are no longer profitable, are outside the seller's core competencies, or are otherwise more valuable to another company.
- **Managing cash flow**. A partial asset sale is also one means for a seller to create new sources of cash if the seller is concerned about running out of money for operations or necessary research.

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Source: Business Law/Intellectual Property in Business Transactions/3 Structuring Transactions Involving Intellectual Property/§3.41 c. Countervailing Considerations

§3.41 c. Countervailing Considerations





A partial asset acquisition or sale may not be advisable if one or more of the following issues presents a serious problem:

- **Need for selectivity may limit the buyer's options.** If a company is not sure precisely which assets it needs to attain its production goals, this structure can be limiting and difficult. For example, the company might make the purchase and later discover that additional intellectual property rights are necessary and that its production processes must be delayed until the additional rights can be obtained.
- **Selling specific assets may present operational risks for the seller.** The seller must be sure that its continuing business will not need what it is proposing to sell. If the company sells off too much, or does not retain necessary intellectual property rights through license agreements, the company's subsequent activities could inadvertently infringe the IP rights that it just sold. This is particularly important when patents are involved.
- **Detailed due diligence is necessary.** The buyer must perform its due diligence carefully to ensure that it knows exactly what it is getting, both in regard to transferred assets and associated liabilities. Each asset must be identified or else a "sufficiency" representation (as in the following example) must be given, and the chain of title must be documented. For a detailed discussion of due diligence in an intellectual property context, see chap 4. An example of the type of representation that the buyer may wish to negotiate is as follows:

  Seller represents and warrants that the transferred assets are sufficient for the purpose of conducting the business of _ _[*identify business unit being transferred as defined in the agreement*]_ _, as currently being conducted by seller _ _[*and as proposed to be conducted by the buyer*]_ _.

- **Successor liability is a risk.** The buyer must look carefully for indicators of successor liability. A buyer may unintentionally take on certain seller liabilities attached to the assets in certain circumstances, even if those liabilities were not disclosed to the buyer in advance of the acquisition or expressly included as transferred liabilities in the agreement. This problem typically arises when the buyer is acquiring substantially all of the assets of the seller's business. See generally Kuney & Looper, *Successor Liability in California*, 20 CEB Cal Bus L Prac 50 (Spring 2005).

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§3.42 d. Financial Considerations

An asset acquisition may be funded with cash or stock, or some combination of the two. Naturally, the client will need to carefully consider the tax consequences of each alternative. Acquisitions made with cash are usually taxable immediately to the seller, depending on the seller's basis in the assets sold, while a seller can defer tax on acquisitions funded with stock until the shares are sold. For further discussion of tax issues in business transactions involving intellectual property, see chap 10. See also Sales and Mergers of California Businesses, chap 3 (Cal CEB 2002).

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§3.43 e. Drafting Considerations

The following are some key considerations in preparing for the acquisition and drafting acquisition documents:

- **Look for encumbrances and continuing third party rights.** The buyer should do careful diligence to confirm good title in all intellectual property assets and to learn whether the seller has granted any rights in the assets to third parties through preexisting license agreements. The buyer should also look for encumbrances or other limitations on its ability to fully realize the value of the business unit being transferred as described in the agreement. The process of due diligence for IP-focused transactions is the subject of chap 4.
- **Describe assets purchased, not what is staying.** Intellectual property asset acquisitions and sales are generally documented in standard asset purchase and sale agreements. The agreements itemize and describe precisely what is being acquired and are usually written to be fully inclusive, with everything not described as being acquired staying with the seller. Typically, schedules are attached to the agreement identifying in detail the assets and liabilities being transferred under the agreement. However, this approach may not be feasible for more nebulous rights such as trade secrets and unregistered copyrights, which will require more effort to define properly prior to sale. See chap 7 for discussion of the special IP-related features of a purchase and sale agreement covering IP assets.
- **Collateral documentation.** If there are significant intellectual property assets involved, collateral documents such as intellectual property assignments suitable for filing with applicable United States and foreign registrars will be needed. The collateral documents typically associated with intellectual property-related acquisitions are discussed in chap 8.
- **Grant-backs.** The seller should consider "licensing back" some or all of the intellectual property rights being transferred if the seller will need them in its continuing or anticipated business operations.

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4. Mergers and Complete Acquisitions

§3.44 a. Overview

A merger is a transaction in which one corporate entity merges into another, with the surviving corporation holding the assets and liabilities of both entities. Mergers can be accomplished either directly or through the use of subsidiary or "shell" corporations that become wholly owned by the true acquirer, and are often financed as either a purchase of the target company's shares or a swap of target-for-acquirer stock. A complete acquisition involves the purchase of all, or substantially all, of the assets (or shares) of a company, without a change of either the buyer's or seller's identity. Occasionally, unnecessary residual assets of the target company may be spun off or sold later.

The subject of mergers and acquisitions (M&A) is a large and complex area of corporate law, which normally involves tax, securities, antitrust, and other regulatory issues. Taxation may well be the most important factor in selecting a merger structure. Mergers and complete acquisitions may take place for a number of reasons, such as a desire for horizontal or vertical integration or to diversify holdings by building multiple, unrelated revenue streams within a conglomerate.

Mergers generally take one of three primary forms:

- **Straight merger.** A straight merger generally involves one company merging directly into another (often a larger company integrating a smaller one). Although this structure provides flexibility with respect to the consideration paid, the seller's liabilities will also become the buyer's direct liabilities. Moreover, anti-assignment clauses in the target company's license portfolio may require a third party licensor's consent to assignment, and thus provide the licensor with an opportunity to demand additional concessions from the merger partners.
- **Forward triangular merger.** A forward triangular merger involves a target company merging into a newly formed subsidiary of the acquirer, with the acquirer's subsidiary surviving the merger. Target liabilities remain isolated in the subsidiary, which has the benefit of protecting the assets and business of the acquiring parent company. However, the same anti-assignment clause problem described above for straight mergers may still arise.
- **Reverse triangular merger.** A reverse triangular merger involves a newly formed subsidiary of the acquiring company, into which the target company is merged, with the target surviving the merger but now as a subsidiary of the acquiring company. This form can be used to advantage if the merger would not otherwise qualify as a tax-free reorganization. Further, a reverse triangular merger permits the target company to retain all its assets and liabilities without need to assign them to the parent company. Therefore, this form is often used when critical licenses or other contracts have anti-assignment provisions and there is real concern that consent may not be granted or would be granted only after the counterparty extorts additional consideration from the acquirer. (Note that change of control provisions may still be triggered.) One unreported U.S. district court case treated a reverse triangular merger as resulting in an assignment. See *SQL Solutions v Oracle Corp*. (ND Cal, Dec. 18, 1991, No. C-91-1079MHP) 1991 US Dist Lexis 21097. Although this case may represent a minority view, the acquiring company must assess the risk of losing critical licenses or triggering undesirable events in contracts that contain anti-assignment provisions. If warranted, the acquiring company should require the target to obtain appropriate consents and waivers as a condition of closing.

For further discussion of structuring issues in intellectual property-focused mergers and acquisitions, see §§6.14-6.20. For general information on mergers and acquisitions, including forms of agreement, readers should consult Sales and Mergers of California Businesses (Cal CEB 2002). See also Klein, Intellectual Property in Mergers and Acquisitions (Thomson West 2004).

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§3.45 b. When Mergers or Complete Acquisitions Are Advantageous

A merger or complete acquisition of the target company's assets may be advantageous if one or more of the following circumstances applies:

- **Seeking the complete package.** The acquiring company wishes to acquire all or substantially all of the target company, including its intellectual property, its customer base, its market share, and its employees. (Of course, in a merger or complete acquisition, the acquiring company will also be buying all of the liabilities—both known and contingent—of the target company. It is therefore very important that careful and complete diligence be done to assure that the buyer knows exactly what it is getting and that risks have been allocated in a fair manner between the parties.)
- **"Acquiring" valuable employees.** In certain knowledge-intensive industries or those where there is an intense battle for talent, which includes almost all aspects of the technology world, skilled employees may be one of the most valuable assets of the target company. A merger or complete acquisition most easily allows the acquirer to step into the previous employer's shoes rather than having to hire away or develop new employees. Of course, some downsizing due to redundancy frequently results from a merger (and is sometimes counted on as a part of the expected synergy). Parties can also require, as a condition of the agreement, that certain key employees sign letters accepting an offer of employment with the acquirer. Nevertheless, managing disruption and defection during the post-merger integration period will be critical to retaining the more valuable employees.
- **Enriching brands and expanding brand and customer families.** A buyer may wish to incorporate the target's technology or products under its own brand, or include a new and valuable brand within its portfolio of existing brands. Compared with other deal structures, mergers permit more seamless movement and utilization of acquired brands. This often has the net effect of both increasing the acquiring company's customer base and eliminating a competitor. (Antitrust considerations may therefore come into play if the buying company has significant market share.)
- **When unassigned rights are desired.** The acquirer may wish to obtain ownership and control over the target in order to exercise rights that the present owner may not care to exercise or assign. For example, the acquirer may wish to have the right to pursue legal action quickly and vigorously against a potential infringer, or the right to prevent a nonexclusive license agreement from being signed with a competitor on terms that the acquirer would not agree to. (The same goals could be secured by contract or license under other structures, however.)

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§3.46 c. Countervailing Considerations

In addition to the primary danger that expected synergies may not materialize, a merger or complete acquisition may not be advisable if one or more of the following issues is a substantial problem:

- **Time sensitivity.** The exploration and execution of a merger may require speed, particularly if two public companies are involved and maintaining confidentiality is essential.
- **Difficulties of downsizing.** Realizing synergies often requires significant change, such as downsizing of duplicative staff and integration of different corporate cultures and processes. Effective post-deal integration can be a substantial challenge, and may damage morale and retention for the remaining employees if not well managed.
- **Persistent liabilities.** In all mergers, share purchases, and most asset acquisitions, certain liabilities will follow acquired assets automatically, making it difficult to avoid accepting some liabilities, or even to know with certainty what liabilities come with the assets.
- **Potential antitrust concerns.** Depending on the size of the parties, there may be significant antitrust concerns. For an overview of antitrust issues, see Miller, *Antitrust for the Transactional Lawyer*, 21 CEB Cal Bus L Prac 69 (Summer 2006). See also Bryer & Simensky, Intellectual Property Assets in Mergers and Acquisitions, chap 7 (John Wiley & Sons, Inc. 2002).

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§3.47 d. Financial Considerations

In general, the financing of an IP-focused merger should not be substantially different from a standard merger, although the existence of intellectual property may influence the form of some risk reduction methods.

- **Use of stock and cash as consideration.** A merger involves acquisition of the target company's stock, either through an exchange of stock or a purchase for cash. Because the target is entirely subsumed into the acquirer, the target company's liabilities follow the assets and a majority vote by target shareholders is required. An outright purchase of stock is also possible, although this may require purchasing the stock of each target shareholder, making the transaction more complex and time-consuming, as well as creating the possibility of holdouts.
- **Risk reduction methods.** Because the value of intellectual property can be both volatile and opaque, the acquiring party can use risk reduction methods in structuring financing for IP-focused mergers to help manage downside risks. Risk reduction methods will be especially important when the intellectual property is relatively new and its market potential is still unknown. One example is the "earn-out," a contractual arrangement under which a seller is compensated based on the future performance of the company or assets sold. An earn-out arrangement helps reduce the buyer's financial risk by enabling some of the ongoing performance risk to be shared with the seller. A second common method is to hold a portion of the sale consideration in escrow for a period of months, to be drawn on by the buyer in recompense should certain problems arise later, as discussed in §3.57.

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VIII. SPECIAL CONSIDERATIONS

§3.48 A. Antitrust Issues

In the context of a merger, industries dependent on intellectual property have certain characteristics that may, at least in theory, increase the likelihood of encountering antitrust problems. Intellectual property development can require large up-front investment in research and development, followed by relatively low variable costs in actually producing products for the market. This situation puts pressure on companies to reduce unit costs to consumers and find returns through economies of scale and accumulation of market power, particularly in industries where patents or other rights permit active exclusion of infringing products.

The federal government's basic analytical approach is to balance the efficiencies of a proposed merger against its potential anticompetitive effects, although the proper balancing of these factors can be quite complex. In general, counsel should be alert to potential antitrust issues in most mergers (particularly, horizontal mergers), joint ventures or other collaborations between competitors, and exclusive licenses of intellectual property.

Parties contemplating a merger or acquisition that meets or exceeds certain jurisdictional thresholds of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR) (15 USC §18a) are required to file a premerger notification with the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC) and to observe a waiting period before consummating the transaction. The waiting period is intended to provide the agencies with an opportunity to investigate the proposed transaction and determine whether to seek an injunction to block the transaction if it would violate the federal antitrust laws. For an overview of antitrust issues in M&A transactions, see M. Miller, *Antitrust for the Transactional Lawyer*, 21 CEB Cal Bus L Prac 69 (Summer 2006); Sales and Mergers of California Businesses, chap 5 (Cal CEB 2002). The current jurisdictional thresholds can be found in Federal Trade Comm'n, *Revised Jurisdictional Thresholds for Section 7A of the Clayton Act*, 74 Fed Reg 1687 (January 13, 2009), available at http://www.ftc.gov/os/fedreg/2009/january/090113section7aclaytonact.pdf, but practitioners should check the FTC's HSR website at http://www.ftc.gov/bc/hsr/index.shtm to verify that these thresholds remain current. As part of the due diligence process, counsel in any multimillion dollar M&A transaction must determine whether or not an HSR filing is required and if so, comply with HSR requirements. Special antitrust counsel may be needed for this purpose.

With respect to licenses and collaboration agreements, the DOJ and the FTC have published guidelines applicable to each type of structure. See U.S. Dep't of Justice & Federal Trade Comm'n, *Antitrust Guidelines for the Licensing of Intellectual Property* (April 6, 1995), available at http://www.usdoj.gov/atr/public/guidelines/0558.htm, and U.S. Dep't of Justice & Federal Trade Comm'n, *Antitrust Guidelines for Collaborations Among Competitors* (April 2000) available at http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.

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§3.49 B. International Issues

If one of the parties to the transaction is not a United States company, a host of international legal considerations emerge. United States technology transfer laws, foreign antitrust laws, applicable treaties, conventions, and the local law of the relevant non-U.S. nation may directly influence the parties' choice of legal structure for the deal. Issues such as choice of law, choice of forum, the primary language of the documentation, and provisions for dispute resolution will bear on the terms of the parties' basic agreement. Selected international issues are discussed in chap 11. It is usually wise for U.S. counsel to engage local counsel in the relevant foreign country to review the proposed transaction and to assure that it complies with local law.

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IX. DANGERS TO THE TRANSACTION

§3.50 A. Mergers and Acquisitions

Not every transaction ultimately creates value. Some deals fall apart before they ever close, while others are recognized as failures only years later. There are many reasons why a merger or acquisition may fail, and counsel should advise the client along the way about signs of potential problems as they arise. The most common or representative problems are outlined in §§3.51-3.57, although these issues should be familiar to any corporate practitioner.

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§3.51 1. Misperceived Synergies

Once the parties have committed to a transaction, they will be inclined to focus exclusively on the things that confirm that their decision was correct. There is a psychological danger that they will overlook matters that are not consistent with their decision. For example, the buyer may misperceive or overestimate the available synergies, with the result that the new assets underperform relative to the buyer's expectations. See §3.16.

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§3.52 2. Faulty Valuation

There is also the closely related possibility that parties will miscalculate the underlying economic value of the transaction. This can happen if the intellectual property has few potential buyers, if it lacks an easily ascertainable value, if the value of the rights are in decline, or if due diligence was otherwise faulty. As a result, potential cost savings or revenue gains may be valued incorrectly.

Overvaluation can result from a variety of factors, including competitive bidding (also known as the "winner's curse"). Counsel should be aware of these risks and urge the client not only to be cautious in setting value but also not to become so emotionally committed to a transaction that the client is in danger of losing full objectivity. Third party experts, such as investment bankers and other qualified advisors, can play an essential role in helping the client have confidence in the value given in any particular transaction.

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§3.53 3. Clouded IP Title Rights

A deal may lose all or part of its value to the acquiring company if it is ultimately mistaken about precisely what intellectual property rights it actually bought. For example, a company may have acquired certain patents believing that the rights would create a strong, protective position for a particular product or a proposed area of development, only to learn after closing that the patents may be useless because of previously undiscovered "prior art." Similarly, if the acquiring company failed to confirm the chain of title to the core intellectual property rights being acquired, a cloud on that title could arise later, and the need to pay third parties to clear titles could greatly diminish the overall value of the transaction.

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§3.54 4. Unforeseen Liabilities

The acquiring company may have taken on liabilities associated with the newly acquired assets that were not anticipated before the closing of the transaction. The acquired company may not have been large or active enough to attract the legal attention of third parties, but the acquiring company may be. If so, third parties may decide to assert their intellectual property rights against the new owner of the assets. Similarly, other third party claims (not adequately covered by warranties or indemnities in the transaction documents) could arise after closing and undermine the value of the transaction.

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§3.55 5. Postmerger Operational Inefficiencies

In addition to integrating the acquired assets with existing operations (see §3.25), new postclosing operational problems, such as redundancy or non-interoperability, may cause short-term declines in efficiency.

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§3.56 6. Piracy and Infringement

Even with clear title, the acquired assets can be subject to infringement in countries where intellectual property rights are not adequately protected by law.

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§3.57 7. Limited Remedies

In most M&A transactions, the buyer's remedies are limited by contract. It is common for the parties to negotiate some percentage of the purchase price to be placed into an escrow account or otherwise to be held in reserve as a fund to satisfy any claims by the buyer against the seller for breach of representations or warranties or other obligations set forth in the transaction documents. For an example of such an escrow provision, see Sales and Mergers of California Businesses §§12.94-12.97 (Cal CEB 2002). Ordinarily, the escrow period will be limited in duration to a year or two after closing, and thereafter (in the absence of fraud or other actionable torts by the seller) the buyer is unlikely to have any meaningful remedy against the seller under the agreement.

In the case of mergers involving two public companies, when the target company is merged into or becomes a wholly owned subsidiary of the acquiring company and funds are dispersed to the shareholders of the target company, there is ordinarily no meaningful remedy available to the buyer under the contract. As a result, proper due diligence becomes all the more important.

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§3.58 B. Licensing and Collaboration Agreements

Licensing and collaboration agreements can have different risk factors than mergers or acquisitions. In the M&A context, the selling company often goes out of existence at the conclusion of the transaction. In licensing and collaboration agreements, however, the parties enter into a long-term relationship in which they may continue to be dependent on one another, leading to a different set of potential problems. See §§3.59-3.60.

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§3.59 1. License Dangers

In licensing transactions, if there is any ambiguity as to which products will be royalty-bearing and how royalties will be calculated, there will almost certainly be opportunities for conflict later in the arrangement. Similarly, if the license agreement includes a field of use but the term is not clearly defined, the parties may find themselves in disagreement later as markets shift. Because license agreements may last for many, many years, it is essential for the parties to be thoughtful and precise in drafting key terms that will define the scope of the licensee's rights, restrictions on those rights, and royalty payment obligations. This also reinforces the importance of building dispute resolution into the same agreements. For further discussion of issues pertaining to licensing transactions, see chap 5.

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§3.60 2. Collaboration Dangers

In collaboration agreements, perhaps the most significant challenge is the creation of a structure for the transaction that will allow the collaborating parties to work together effectively over time. When two institutions with different working styles, priorities, or financial capabilities are collaborating on a single project, it is extremely important for the agreement to set forth a process for effective communication and resolution of conflicts that may arise over the course of the relationship. Collaboration agreements most often fail as a result of poor communication and misunderstandings that spiral out of control before any effective intervention can get the relationship back on track. It is essential for counsel to understand that the parties will not be able to anticipate all possible issues that may arise over the course of a long, collaborative relationship. Therefore, working with the parties to negotiate and agree on procedures for dealing with change and conflict is far more important than attempting to anticipate every potential area of conflict that might arise.

As discussed in §3.36, collaboration agreements can fall apart as a result of the failure to adequately consider how the rights in new intellectual property created from the collaboration will be shared, if at all. In the life sciences area in particular, collaborations focused on a single goal may result in unanticipated new discoveries that could be economically beneficial to one or both of the parties. It is almost impossible to foresee all of the potential results of the collaboration at the time the collaboration agreement is negotiated.

Collaboration agreements usually contemplate the allocation of different types of resources to a project. Counsel should make sure that the parties have considered and addressed the allocation of costs and what other resources may be needed for the work to continue over time. If one of the parties to the collaboration fails to meet its obligations in terms of resource allocation, the other party may not have sufficient manpower or financial resources to complete the project successfully.

For further discussion of issues pertaining to collaboration agreements, see chap 6.

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Source: Business Law/Intellectual Property in Business Transactions/3 Structuring Transactions Involving Intellectual Property/§3.61 X. ILLUSTRATIVE TERM SHEET FOR COLLABORATION AGREEMENT

§3.61 X. ILLUSTRATIVE TERM SHEET FOR COLLABORATION AGREEMENT

Following is an example of a term sheet for a collaboration agreement. An important consideration in preparing these types of documents is the extent to which any of the terms should be binding on the parties until their formal agreement is concluded. At a minimum, the parties should consider making confidentiality and exclusive negotiation provisions binding for some period of time. Note that many of the terms in the following example are not yet specified and remain to be negotiated by the parties.

ABC Corporation

Summary of Terms - Collaboration Agreement

For Discussion Purposes Only

<table>
<tr><td colspan="2">This Summary of Terms is entered into between ABC Corporation ("ABC") and XYZ Industries ("XYZ") (collectively, the "Parties") as of January ___, 20__, and sets forth the understandings that have been reached between ABC and XYZ with respect to certain commercial matters. It is the parties' intention to negotiate and enter into a definitive agreement that will incorporate these terms (the "Definitive Agreement"). Until such time as the Definitive Agreement has been concluded, the terms set forth herein shall constitute the binding legal obligations of the parties.</td></tr>
<tr><td>Purpose</td><td>[Like "recitals" in a definitive agreement, it is important to describe the intended purpose of the proposed collaboration.]</td></tr>
<tr><td>Product Development Objectives</td><td>Develop and manufacture products employing ABC [technology] and ABC instruments for use in….applications.

Goal of the collaboration to be established is to provide a framework for the development of.… as defined below, for sale to customers for use in.… applications. [To ensure that there is no misunderstanding on exactly what the collaboration is about and what its goals are, it is useful to specify the goals as precisely as possible at the term sheet stage.]</td></tr>
<tr><td>ABC Appointments</td><td>[It is not unusual for collaboration agreements to provide for both joint development of something and subsequent manufacture and or distribution of what is developed. If that is the case, the appointment by one party or the other as supplier or distributor (or both) should be included.]</td></tr>
<tr><td>Joint Development Program</td><td>Costs. Each Party will pay its own costs and expenses in connection with its activities in furtherance of the Joint Development Program. [There may be some other arrangement on expense payment or sharing.]

Termination. Unless otherwise agreed by the Parties in writing, the Joint Development Program may be terminated by either Party, for any reason or no reason, on written notice to the other Party.

Joint Undertaking. If the Parties agree in writing to a joint development program, the Parties will use</td></tr>
</table>

	commercially reasonable efforts to perform their assigned duties and responsibilities and achieve the goals of the Joint Development Program. ***Information Exchange.*** The Parties will use reasonable efforts to keep each other informed with respect to all activities directly related to a Joint Development Program, including without limitation access to design plans and drawings, specifications, engineering change orders, software, supplier information, processes, materials, validation information, and chemistries directly related to the Joint Development Program. Both Parties will participate in milestone reviews in accordance with a schedule to be agreed on by them. ***Development Teams.*** Each Party will assign personnel to its development team for a Joint Development Program who it believes have the appropriate skills and experience to accomplish the work established in the Work Plan or to otherwise achieve the goals of the Joint Development Program. It is expected that such teams will work together to accomplish the goals of the Joint Development Program including, if appropriate, conducting efforts at the same facility.
Joint Steering Committee	***Purpose.*** A joint steering committee will be established to oversee the relationship of the Parties under the Definitive Agreement and any Joint Development Programs established thereunder ("Joint Steering Committee"). The duties of the Joint Steering Committee will include, but will not be limited to, the following: general oversight of all aspects of Joint Development Programs, including definition, development, manufacturing (supply), marketing, sales, and support of Products; development and implementation of Work Plans; development and approval of budgets; organization of development teams and general oversight of their activities; review of forecasts for Net Sales of Products; and initial forum for the resolution of disputes arising under the Definitive Agreement. **Membership.** The Joint Steering Committee will be comprised of 3 employees from ABC and 3 employees from XYZ. ***Joint Steering Committee Decisions and Dispute Resolution.*** A quorum for the conduct of business at meeting of the Joint Steering Committee shall consist of at least 2 members from each Party. Decisions by the Joint Steering Committee will be made by consensus, that is, all members in attendance at a meeting at which there is a quorum must agree. If the Joint Steering Committee is unable to reach agreement on a matter, within 10 business days the matter will be submitted for resolution to the Chief Executive Officer of each of the parties. In the event that the Chief Executive Officers of the Parties cannot reach agreement within 10 business days after receiving notice from the Joint Steering Committee, which period may be extended by mutual agreement of the Parties, then either Party may initiate mediation to resolve the matter in accordance with the rules and procedures set forth in the Definitive Agreement. *[This is only illustrative of a*

	possible approach to dealing with disputes. There are myriad ways of resolving potential conflicts; it is important to consider including at least some mechanism for this purpose to avoid uncertainty or to leave parties unclear.] ***Records of Decisions.*** It is anticipated that significant decisions of the Joint Steering Committee, such as approval of budgets, will be reflected in written minutes of meetings that will be circulated to all Joint Steering Committee members for review and comment before being filed as final records of the Joint Steering Committee. ***Expenses.*** The Parties will each bear all expenses of their respective members related to their participation on the Joint Steering Committee.
Intellectual Property	*[It is important to define the various types of IP and what the parties' rights are and will be. The following is an illustrative approach.]* ***Generally.*** All rights, title, and interest in and to Background Intellectual Property of a Party, whether patentable or copyrightable or not, will belong to and be retained by the owner of such Background Intellectual Property and will be subject to the terms and conditions of the Definitive Agreement. ***Collaboration Joint Intellectual Property.*** All rights, title and interest in and to Collaboration Joint Intellectual Property, whether patentable or copyrightable or not, will belong jointly to XYZ and ABC and will be subject to the terms and conditions of the Definitive Agreement. Each Party will have the right to independently practice the Collaboration Joint Intellectual Property, without accounting to the other Party, only to the extent that the practice of the Collaboration Joint Intellectual Property by XYZ does not require rights under Background ABC Intellectual Property, or any other Intellectual Property Rights owned by, either partially or wholly, or licensed to ABC (other than by XYZ), and that practice of the Collaboration Joint Intellectual Property by ABC does not require rights under Background XYZ Intellectual Property, or any other Intellectual Property Rights owned by, either partially or wholly, or licensed to XYZ (other than by ABC). Additionally, each Party will have the right but not the obligation to bring, at its own expense, an infringement action against any Third Party under its interest in Joint Collaboration Intellectual Property, subject to the same limitations set forth above with respect to the practice of the Joint Collaboration Intellectual Property by ABC or XYZ. The Parties will assist one another and cooperate in any such litigation at the other's reasonable request, and if a Party is necessary in order to institute or maintain an infringement suit by the other Party as provided by law, that Party agrees to be joined in the suit at the expense or the prosecuting Party.
Patent Applications	*[It may be useful to include provisions such as the following. There are many approaches that one could take; the language below only illustrates one potential approach. Typically, the language in the term sheet will be much more abbreviated than the following.]*

Collaboration ABC Intellectual Property. ABC will have the first right, using in-house or outside legal counsel selected by ABC's sole discretion, to prepare, file, prosecute, maintain, and extend patent applications for Collaboration ABC Intellectual Property in countries of ABC's choosing. ABC will bear all costs relating to such activities. ABC will solicit XYZ's advice and review of the patent applications, and ABC will take into consideration XYZ's advice thereon, but whether to implement such advice shall be in ABC's sole discretion.

If ABC elects not to prepare, file, prosecute or maintain certain of the patent applications or any claims encompassed within the patent applications in one or more countries, ABC will give XYZ notice thereof within a reasonable period prior to allowing the patents or claims to lapse or become abandoned or unenforceable, and XYZ will thereafter have the right, at its sole expense and discretion, to prepare, file, prosecute, and maintain the patent applications or, by means of continuations in part, divisionals or other appropriate methods, claims, in the name of XYZ in the one or more countries. ABC will, at XYZ's expense, assign the patent applications and claims to XYZ and provide reasonable assistance to XYZ to facilitate the filing and prosecution of all the patent applications or claims that ABC has elected not to pursue, and ABC will execute all documents reasonably deemed necessary or desirable by XYZ therefor.

Unless otherwise agreed by the Parties in writing, XYZ will provide to ABC a royalty-free, worldwide, perpetual, non-exclusive license, with right to sublicense, under all the patent applications and claims that ABC has elected not to pursue and XYZ has elected to pursue under the Definitive Agreement. If claims describing Collaboration ABC Intellectual Property are combined in a patent application with claims describing Background ABC Intellectual Property that is not Collaboration ABC Intellectual Property, XYZ's rights hereunder will be limited to those claims describing Collaboration ABC Intellectual Property. XYZ and ABC will each hold all information it presently knows or acquires hereunder as Confidential Information.

Collaboration XYZ Intellectual Property. XYZ will have the first right, using in-house or outside legal counsel selected by XYZ's sole discretion, to prepare, file, prosecute, maintain, and extend patent applications for Collaboration XYZ Intellectual Property in countries of XYZ's choosing. XYZ will bear all costs relating to such activities. XYZ will solicit ABC's advice and review of the patent applications, and XYZ will take into consideration ABC's advice thereon, but whether to implement such advice shall be in XYZ's sole discretion.

If XYZ elects not to prepare, file, prosecute, or maintain certain of the patent applications or any claims encompassed within the patent applications in one or more countries, XYZ will give ABC notice thereof within a reasonable period prior to allowing the patents or claims to lapse or become abandoned or unenforceable, and ABC will thereafter have the

right, at its sole expense and discretion, to prepare, file, prosecute, and maintain the patent applications or, by means of continuations in part, divisionals or other appropriate methods, and claims in the name of ABC in the one or more countries. XYZ will, at ABC's expense, assign such patent applications to ABC and provide reasonable assistance to ABC to facilitate the filing and prosecution of all the patent applications and claims that XYZ has elected not to pursue, and XYZ will execute all documents reasonably deemed necessary or desirable by ABC therefor.

Unless otherwise agreed by the Parties in writing, ABC will provide to XYZ a royalty-free, worldwide, perpetual, non-exclusive license, with right to sublicense, under all the patent applications that XYZ has elected not to pursue and ABC has elected to pursue under the Definitive Agreement. If claims describing Collaboration XYZ Intellectual Property are combined in a patent application with claims describing Background Collaboration XYZ Intellectual Property that is not Collaboration XYZ Intellectual Property, ABC's rights thereunder will be limited to those claims describing Collaboration XYZ Intellectual Property. XYZ and ABC will each hold all information it presently knows or acquires thereunder as Confidential Information.

Collaboration Joint Intellectual Property. XYZ and ABC will jointly have the right, using in-house or outside legal counsel selected by both Parties, to prepare, file, prosecute, maintain, and extend patent applications for Collaboration Joint Intellectual Property in countries of the Party's choosing. However, if the practice of the Collaboration Joint Intellectual Property would necessarily infringe claims of patents or patent applications claiming Background XYZ Intellectual Property, the Collaboration Joint Intellectual Property will, for the purposes of this Section only, be treated as Collaboration XYZ Intellectual Property, and if the practice of the Collaboration Joint Intellectual Property would necessarily infringe claims of patents or patent applications claiming Background ABC Intellectual Property, the Collaboration Joint Intellectual Property will, for purposes of this provision, be treated as Collaboration ABC Intellectual Property. If only one Party ("Filing Party") desires to file a patent application in one or more countries, then the Filing Party will thereafter have the right, at its sole expense, to prepare, file, prosecute, and maintain the applications in its own name in the one or more countries, and the other Party will, at its own expense, assign such patent applications to the Filing Party and provide reasonable assistance to the Filing Party to facilitate the filing and prosecution of all the patent applications that the other Party has elected not to pursue, and the other Party will execute all reasonable documents deemed necessary or desirable by the Filing Party therefor.

The Filing Party will provide to the other Party a royalty-free, worldwide, perpetual non-exclusive license, with right to sublicense, under all the patent applications that the other Party has elected not to pursue and the Filing Party has elected to pursue

	under the Definitive Agreement. XYZ and ABC will each hold all information it presently knows or acquires thereunder Confidential Information.
Patent Litigation	*[If the collaboration is in a field in which there could be patent issues, it may be useful to include provisions addressing how patent litigation will be handled.]* ***Defense Against Third Party Claims; Sharing of Costs for Certain Third Party Infringement Claims.*** ***Prosecution of Infringement Action.*** ***Expenses.*** ABC and XYZ have the right to first recover their respective actual out-of-pocket expenses, or proportionate share thereof, in connection with any litigation or settlement thereof from any recovery made by any Party. Any excess amount will be shared between XYZ and ABC in an amount proportional to their respective out-of-pocket expenses. ***Information.*** The Parties will keep one another reasonably informed of the status of their respective activities regarding any such litigation or settlement thereof.
Branding	***Branding, Trademarks, and Non-Proprietary Names***. Products distributed to end users will be branded in such a manner that both Party's logotypes will appear with approximately equal weight and size on all packaging, product inserts, and accompanying literature, except to the extent the Parties otherwise agree. Unless otherwise agreed, the logotypes and brands on Products will appear on all packaging, labels, and product inserts as designated in the Definitive Agreement.
Exclusivity	***Exclusivity.*** *[If the parties contemplate exclusivity as a component of any aspect of their collaboration, that fact should be clearly spelled out, including circumstances under which exclusivity obligations would terminate.]*
Product Supply	*[If the agreement will include product supply or distribution arrangement, provisions such as the following may be useful.]* ***Production and Sales of Products.*** ABC shall be responsible for production and sales of Products, including as a distributor of Products purchased from XYZ, to customers, either directly or Third Party distributors selected by ABC. ***Sales Forecasts.*** ***Pricing.*** ***Value Sharing.*** ***Reimbursement and Payment Process.*** ***Books and Records; Audit.***
Confidentiality	*[Unless the parties have previously entered into a confidentiality agreement, that topic should be addressed and the provision should be binding.]* *[Because the parties will get to know each other well, it may be useful to include a non-solicitation provision*

	such as the following.] ***Non-Solicitation.*** During the term of the Definitive Agreement and for a period of 1 year thereafter, a Party will not solicit any person who is employed by or is an exclusive consultant to the other Party and directly involved with the Joint Development Program or the collaboration to terminate that person's employment by or consultancy to the other Party.
Terms and Termination	*[The parties should indicate the term of the proposed collaboration and the bases for termination of it.]* ***Term.*** ***Termination.*** The Definitive Agreement may be terminated without cause by mutual written agreement; bankruptcy event; or material breach. ***Survival of Obligations and Certain Rights.*** Upon any termination of the Definitive Agreement, by expiration of the term or otherwise, neither Party will be relieved of certain obligations specified under the Definitive Agreement incurred prior to such termination.
Representations and Warranties	Each Party will make the standard representations, warranties, and covenants to the other Party regarding its lawful power to enter into the Definitive Agreement, the absence of any other conflicting agreements, and the proper execution of employee assignment agreements.
Disclaimers	Except to the extent otherwise expressly set forth in the Definitive Agreement, standard disclaimers regarding the validity, enforceability, or scope of any patent or other intellectual property will apply.
Indemnification and Limitation of Liability	*[The collaboration agreement will typically include provisions dealing with indemnification and limitations of liability.]*
Insurance	*[The parties may want to provide for specific insurance coverage to address risks associated with the collaboration.]*
General Provisions	The Definitive Agreement will contain such other terms and conditions as the Parties shall agree and as are customary for agreements of this sort. *[If applicable, the commitment of the parties to negotiate and enter into the Definitive Agreement by some date certain should be set forth here. Similarly, the parties may want to specify here which provisions of the term sheet, if any, are intended to be legally binding on the parties.]*
Dispute Resolution	*[The parties may wish to include a dispute resolution provision. Given that these types of agreements typically create on-going working relationships, the parties may want to choose an approach to dealing with conflicts such that the relationship is most likely to be preserved. The following is an illustrative provision.]* The parties shall attempt to resolve any dispute arising out of relating to the agreement promptly by negotiation between executives who have authority to settle the controversy.

	If the parties do not resolve the dispute within 45 days of undertaking negotiation thereof, either Party may refer the dispute for mediation by _____ by providing to the other Party a written request for mediation, setting forth the details of the dispute and the relief requested. Each Party shall then participate in the mediation in good faith and share equally in its costs. If the dispute has not been resolved by nonbinding means as provided in the Definitive Agreement within 90 days of the initiation of such procedure, either Party may pursue available remedies, including litigation. Notwithstanding the foregoing, each Party shall have right before or during negotiation or mediation to seek and obtain from the appropriate court provisional remedies such as attachment, preliminary injunction, or replevin to avoid irreparable harm, maintain the status quo, or preserve the subject matter of the negotiations or mediation.
	[Add signature blocks at end.]

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4

Intellectual Property Due Diligence

John E. Wehrli

I. INTRODUCTION §4.1

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§4.1 I. INTRODUCTION

In this post-Enron and WorldCom world, companies and their accountants, bankers, and lawyers are being held to higher standards of disclosure and are more accountable to governmental agencies and stockholders. All players now face greater liability and, as a consequence, are required to exercise greater care in consummating business transactions, including those in which intellectual property is important.

In the author's experience, intellectual property due diligence is a concept that is familiar to many business lawyers, but at the same time is not well understood. Because intellectual property is so central to many industries, intellectual property due diligence is of central importance in many transactions. Consequently, the IP due diligence team will often be critical to the success of the transaction, and the work it performs will often constitute the most significant portion of the entire transaction from a time and human resource perspective. Often, however, the business attorneys leading the transaction (whether a merger, an acquisition, or a public financing) may not realize the importance of intellectual property—and thus IP due diligence—to the transaction, and IP counsel may be brought in at the last minute without the benefit of having been involved in the transaction from the start. Regardless of when IP counsel becomes involved, adequate due diligence is important not only to the legal and business aspects of the transaction as a whole, but also to mitigate the potential liability of participants.

This chapter is intended to provide practical guidance on conducting intellectual property due diligence for various types of business transactions in various industries. No single approach is appropriate for all transactions. This chapter therefore attempts to provide the context and perspective necessary to understand the "why" of due diligence, so that the "how" will become self-evident from the nature of the transaction, the industry, and the intellectual property involved. To borrow Enron's ironic advertising slogan, counsel must "Ask Why?"

This chapter first defines intellectual property due diligence (see §§4.2-4.10), provides a context for it, and answers the question why it is done (see §§4.11-4.13). This chapter does not attempt to provide step-by-step instructions for performing due diligence in a myriad of transactions with unique circumstances, but instead attempts to provide the tools to evaluate a given transaction and enable counsel to design an IP diligence investigation of appropriate scope, depth, and character to meet client expectations and needs, as well as legal requirements. See §§4.15-4.19, 4.42-4.50. With a proper theoretical context and framework in place, counsel can give practical advice on conducting IP due diligence for patents, trademarks, copyrights, and trade secrets (see §§4.20-4.36) in the types of transactions in which IP due diligence may be critical (see §§4.51-4.71). A model due diligence checklist is provided in §§4.72-4.73.

NOTE: This chapter focuses on U.S.-based transactions governed by United States law, including U.S. intellectual property law. When state law is applicable, this chapter presents material from the perspective of California law. Due diligence questions concerning other states or nations outside the United States should be referred to local intellectual property experts in those jurisdictions.

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II. WHAT IS INTELLECTUAL PROPERTY DUE DILIGENCE AND WHY DOES IT NEED TO BE DONE?

§4.2 A. Definition of Intellectual Property Due Diligence

The Black's Law Dictionary definition provides an initial context for due diligence. It identifies the key elements and provides the essential framework for the scope and goals of all intellectual property due diligence projects. By focusing on these elements, counsel can give meaning to the due diligence process and identify the material items that must be made the subject of investigation. The definition of due diligence in the Sixth Edition of Black's is (Black's Law Dictionary 457 (6th ed 1990)):

> Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.

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§4.3 1. Definitional Context

Key points from the Black's definition in §4.2 include the notion of a "reasonable" standard that is measured by the "relative facts of the special case." There are two elements that comprise, on the broadest measure, the facts particular to a given due diligence investigation:

- The nature of the transaction (see §4.4); and
- The industry of the entity subject to diligence review (see §4.5).

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.4 a. Nature of Transaction

§4.4 a. Nature of Transaction

From the perspective of the target entity, the nature of the transaction will be either:

- An investment by a private party (*e.g.,* a venture capital investor, an "angel," or another company);
- An underwriting for a public offering of securities (*e.g.,* an initial public offering, a follow-on or secondary offering, or an SEC Rule 144A (17 CFR §230.144A) restricted stock offering);
- A merger of two entities, or an acquisition of all or a portion of the assets of an entity; or
- A commercial transaction, such as a license, distribution arrangement, major promotion or marketing relationship, or major collaboration.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.5 b. Industry of Target Entity

§4.5 b. Industry of Target Entity

Each industry has its own particular features, which alter the focus of due diligence and provide "hot items" encountered often in that industry. For example, the life sciences industry (*i.e.*, biotechnology and pharmaceutical companies) is characterized by the following unique elements, which provide a common context for diligence investigations and differentiate diligence investigations in the life sciences industry from those in other industries:

- Long product development cycles (*e.g.,* 8-15 years);
- A high dependence on patent protection;
- Lack of profits until product approval;
- Regulation by the FDA or equivalent foreign body; and
- Prevalence of outsourcing and partnering, and the materiality of agreements embodying these types of transactions.

In contrast, the software industry is characterized by other factors that color due diligence investigations of its market participants, *e.g.*:

- Short product development cycles (*e.g.,* 6 months to 3 years);
- A high dependence on copyright protection and increasing dependence on patent protection;
- High development costs relative to product cost and end-user price; and
- Prevalence of point-of-sale end-user transactional economics.

Other industries, either subcategories of the industries above (*e.g.,* medical devices or video games) or separate industries (*e.g.,* entertainment, publishing, or transportation), are characterized by still other factors that make them unique, drive their economics, and define their risk.

The process of identifying, and tailoring the investigation to, the target industry is discussed further in §§4.15-4.19. With the unique industry factors identified, counsel can then identify generally:

- The appropriate scope of diligence review (see §§4.6, 4.20-4.36); and
- The standard to be applied (see §§4.7-4.9).

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.6 c. Scope of IP Due Diligence Review

§4.6 c. Scope of IP Due Diligence Review

The scope of an intellectual property due diligence investigation is largely driven by the type of intellectual property involved and the quantity of the particular type of intellectual property that must be reviewed. Some transactions may require greater focus on one type of intellectual property. Regardless of the nature of the transaction, some level of review of company patents, copyrights, trademarks, trade secrets, and licenses; original equipment manufacturing (OEM) agreements, value-added reseller (VAR) agreements, and other manufacturing and supply agreements; collaboration agreements; and other intellectual property agreements will be in order. The IP focus is defined by the industry, and the scope of review is determined by the nature of the transaction.

NOTE: Because the focus of this chapter is *intellectual property* due diligence, this chapter does not address general corporate due diligence that would be performed by other members of the diligence team.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.7 d. Standard Applied

§4.7 d. Standard Applied

Referring back to the Black's definition in §4.2, the standard applied depends on the "relative facts of the special case." More often than not, the standard by which counsel measures a due diligence investigation is dictated by the nature of the transaction and industry practice (both the industry of the entity subject to the due diligence review and the industry of the entity conducting it). In that context, the standard is determined by:

- Client expectations and objectives, including the impact of time constraints (see §4.8); and
- Legal constraints (§4.9).

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§4.8 (1) Client Expectations and Objectives

In every due diligence project, the client has particular goals, which are dependent on the nature of the transaction. If the client is a company acquiring another company, whether the transaction is structured as a true merger or an asset purchase is of key importance. Assumption of liabilities normally differs in the two structures, and this factor influences the scope of diligence required.

Client expectations also vary. Often a client will have a particular budget in mind, and counsel must manage the due diligence review accordingly. The client may also be in a competitive bidding situation or otherwise may be facing tight time limitations. Such financial and time constraints will impact client expectations and objectives, and may require limiting the scope of diligence review or limiting its depth. By following the suggestions in §§4.43-4.50, counsel can help provide the most effective IP due diligence service possible within the client's financial and time constraints.

The client may also wish to split the investigation, having in-house or outside patent counsel focus on patent diligence, trademark counsel focus on trademark diligence, and other counsel focus on a review of IP agreements and related disclosures to federal agencies. It is always a good idea to ask the client precisely what its objectives and expectations are, although a client will often respond by asking counsel what they should be. If counsel has already considered the appropriate scope of the investigation, counsel should be able to provide appropriate guidance on what is needed, as distinct from what is required. Often the client may need more information than what is required by law.

PRACTICE TIP: Many clients have only a fuzzy notion of what IP due diligence means, and may have expectations of what counsel can offer that are not congruent with what counsel can actually deliver or accomplish. If the client turns back to counsel for guidance on what its expectations should be, it is critical to ensure that those expectations are realistic and are clearly described for the client, both at the outset and throughout the project. It is particularly important to discuss the work product to be delivered, what it will and will not contain, and why. See §§4.37-4.40. This will avoid the client's receipt of a work product developed with great effort by counsel, but not matching the client's expectations.

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§4.9 (2) Legal Constraints

This chapter discusses the legal constraints on diligence investigations in the context of each type of transaction identified in §4.4. See §§4.51-4.71. Often it is best to "ask why" perform due diligence to begin with. Although business reasons should drive the process, at least part of the answer will be to meet a legal standard set by law or by a regulatory body. For example, an appropriate due diligence investigation can serve as a foundation for successful assertion of the business judgment rule (see §4.68) or the reliance on counsel or due diligence defense (see §4.63) in any subsequent litigation.

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§4.10 e. Intellectual Property Due Diligence (Author's Definition)

In this context, the author proposes a more intellectual property-specific definition of due diligence, that captures all the key elements of any IP due diligence exercise:

> Intellectual property due diligence is a detailed investigation of relevant matters of an entity that relate to intellectual property, with a particular focus on relevant types of intellectual property, agreements that relate to such intellectual property, and, in certain cases, freedom to operate, with the twin goals of quantifying risk as dictated by the economics and other characteristics of the entity's industry and the nature of the underlying transaction, and meeting relevant legal standards or requirements.

The additional elements of this definition are discussed in §§4.11-4.14.

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B. Why Perform Due Diligence?

§4.11 1. Business Reasons: to Quantify Risk

Whether the client is an investor, purchaser, seller, or potential partner, the primary objective in due diligence is to identify and quantify risk. What this really means is to:

- Identify what particular items of intellectual property expose the entity to its greatest business and legal risk and, as a consequence, financial and legal liability; and then
- Characterize the risk and enable a probability (p value) to be assigned to it, either figuratively or literally. The word "figuratively" is used because assigning a number to risk is not always feasible.

This chapter addresses risk assessment for both buyers or investors and sellers in the particular types of transactions discussed in §§4.51-4.71. Risk is characterized by some measurable potential loss and reflects uncertain outcomes of events. In IP-focused business transactions, the risk is both business risk—often characterized in terms of potential for financial loss—and legal risk—often characterized in terms of exposure to third party litigation claims or governmental scrutiny, which can result in financial loss or loss of some personal or business freedom. At least in theory, if uncertainty is reduced, the probability of loss, and thus risk, is also reduced.

Those who study game theory dwell in the world of probabilities. Transactions that are the subject of due diligence investigations are similar to probabilistic games or gambles. Any good gambler should seek to identify the unique parameters that help define the probabilities associated with success in the game. The more conservative the gambler, the more thorough due diligence is required, because the gambler's intolerance for uncertainty is greater. In the due diligence context, the party conducting the review will alter the amount of diligence performed depending on its level of risk tolerance. If it is risk-averse, diligence may be extensive. If it is very tolerant of risk, it may be inclined to conduct no diligence at all. Moreover, it may be able to reduce its risk by reallocating risk to the target company or requiring price concessions or conditions to closing the transaction. In some circumstances, if the risk is too great, the transaction will not be consummated.

Consequently, the output of an IP diligence review should enable the client to identify what it is receiving from, or investing in, the transaction and to help quantify any uncertainty associated with the transaction. If the target entity is a for-profit company, the client needs to be able to predict revenues and profits with some level of confidence. This is often the central component of the value of the deal to the client if it uses a net present value (NPV) or discounted cash flow (DCF) analysis to support pricing of the transaction. Due diligence can identify the key elements to use as inputs to a valuation calculation.

What kinds of things can be uncovered in an intellectual property due diligence review of a target entity that may enhance uncertainty, and thus risk? Counsel may find that the target does not own the rights to the patents that it thinks it owns, or that the target has sought copyright protection when it should have sought patent protection. Counsel may find that the target's patents do not provide adequate protection, or that the target does not have all the rights it needs to conduct its business. Counsel may find that the target has some obligation to a third party that will hinder its independence, its business, or its potential for profit. Counsel may find that the target is exposed to significant patent or contract litigation risk, or that there is a defect in some legal instrument that negates a right. Counsel may even uncover more nefarious matters with criminal implications. Although some issues can be corrected before closing the transaction, others cannot be, and may result in the client's withdrawing from the transaction, or at least repricing it.

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2. Legal Reasons: Liability and Affirmative Defenses

§4.12 a. Liability

In the context of due diligence investigations, the gambler—the party at risk—may not only be the client, but may also be a regulatory body or a third party beneficiary of the transaction such as a stockholder or other interested party. If so, an assessment of risk must include the expectations and standards of that third party or parties. Some third parties, such as stockholders, are protected by federal and state securities laws and rules that may give them a cause of action against the securities issuer and other participants in the transaction if their economic interests are not sufficiently protected by adequate disclosure in advance of the economic risks of the transaction. The potential economic interests of third parties are determined by the level of their risk in the transaction, and that level of risk is quantified through a due diligence investigation. As a result, even if the client is tolerant of risk and not self-motivated to conduct extensive due diligence, it will be motivated by potential legal liability to third parties, and the client must quantify that legal liability through proper due diligence.

Legal liability also attaches to direct violations of laws relating to the due diligence process itself, *i.e.,* laws intended to protect interested third parties by requiring some level of diligence and setting a standard of care. See §§4.61-4.63, 4.68. The client must therefore conduct diligence both to quantify and to limit its liability and to ensure its compliance with applicable laws, rules, and regulations.

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§4.13 b. Affirmative Defenses

Another reason for a party to conduct IP due diligence is to enable the party to assert an affirmative defense to a claim by demonstrating that it met a certain legal standard of diligence review. See §§4.60-4.63, 4.68. In fact, the particular standard necessary to enable a party to assert an affirmative defense is often the key guiding principal in certain diligence investigations and will determine the level of diligence sufficient for a given transaction. Objective legal standards are particularly useful in certain transactions involving intellectual property because they help normalize differing levels of risk tolerance among the participants. In other words, affirmative defenses help standardize due diligence in certain types of transactions, irrespective of the variability of other factors, and help improve the cost efficiency of the process.

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§4.14 C. Need for Expertise

Intellectual property due diligence is analogous to a very thorough physical examination of a patient by a doctor. The physician needs to ask questions about the patient's health, health history, and what medical conditions exist. But the physician cannot simply take the patient's word. The physician must perform tests to confirm the patient's statements, and the tests can be broad or specific based on the physician's initial interview and examination. The physician analyzes the test data, makes a diagnosis, and then determines whether the patient's conditions are material or minor and whether they can be corrected or are terminal. Because of the importance of a correct diagnosis, the physician must conduct the examination with skill, care and diligence.

Two key elements of the physician's Hippocratic Oath are applicable to intellectual property due diligence:

- First, do no harm.
- Second, avoid attempting to do things that other specialists can do better.

The second element is particularly important. Intellectual property is a technical area of law that often requires not only specific legal skills, but also advanced nonlegal skills, depending on the type of intellectual property and its subject matter.

For example, if patents dominate an industry, the underlying technology determines the technical skills demanded of a patent specialist, such as chemistry, mechanical engineering, biology, or computer science. In addition, an in-depth knowledge of patent law is paramount. If patents for a biotechnology company must be reviewed to determine whether the company has the appropriate monopoly power to generate adequate profit margins, counsel should have a background in molecular biology or biochemistry and be a registered patent attorney or agent, or at least someone who has assisted in drafting patent applications or litigated patents sufficiently to thoroughly understand the lingua franca of the patent world. Moreover, conducting patent due diligence in the context of commercial transactions is quite different from drafting applications or litigating patents. Many specialists may be needed to work as a team to ensure that key issues are identified and correctly evaluated.

Patent due diligence is different from claim construction and prior art searches. Claim construction is conducted in the context of patent litigation and involves construing patent claims to determine how they may be interpreted for purposes of infringement analysis and validity. It is a very precise exercise. Prior art searches are conducted in the context of filing and prosecuting patent applications before the U.S. Patent and Trademark Office and involve a search of prior patents and publications that may impact the patentability of a patent application or the validity of a patent. Although a due diligence investigation of a patent may have elements that are similar to claim construction or prior art searches, because the focus is different, the exercise is different and should be conducted by those familiar with the differences.

Due diligence investigations concerning other areas of intellectual property law, such as trademarks and copyrights, may not require an advanced scientific degree, but may require great familiarity with issues unique to the intellectual property in the particular industry, such as entertainment, consumer goods, or communications.

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III. FRAMEWORK FOR CONDUCTING IP DUE DILIGENCE

§4.15 A. Tailoring Investigation to Target Industry

The key initial questions, "What should we focus on, and how deeply should we look into a particular type of intellectual property?" can be answered, at least in part, by understanding the target industry and the particular market participant that is the subject of the diligence investigation. See generally §4.5.

The nature of the target industry will dictate to a great extent the scope of diligence review. Different industries rely on various forms of intellectual property protection to different degrees, depending on the nature of the revenue-generating products of the industry. Industries in which the typical product is a type of information, such as software, may rely primarily on one type of IP protection, while an industry in which the typical product is a mechanical object may rely on another. For example, a recipe for a soft drink, a medical device, a motion picture script, a drug, a domain name, software, a book, and a brand are all, or are all related to, products. Their importance, and whether they can benefit from a particular type of intellectual property protection, derives from the economics of their respective industries. In effect, how market participants in the industry compete will dictate the type of intellectual property most critical to that industry, regardless of whether the product is suited to a particular type of IP protection.

From an economic perspective, intellectual property is just one of a number of entry or participation barriers for market participants. The more barriers, the more difficult it is to enter the relevant market, and the easier it is for existing participants to exercise monopoly power. In some industries, IP can be the most significant barrier. In others, it may be completely irrelevant. Because of how market participants compete in a given industry, one form of IP protection may be more important than another, more obvious one.

For example, Coca-Cola is a product. It is a soft drink, and its chemical formula should qualify for patent protection. But that protection would expire after 20 years (see 35 USC §154(a)(2)). Moreover, the soft-drink industry is, on a product-by-product basis, highly fragmented. There are many substitute products available, and this fact suggests that if the Coca-Cola formula became public information, it would be copied, and nothing could prevent consumers from purchasing generic equivalents. It happens that the formula for Coca-Cola is difficult to reverse engineer, and this is often a key consideration for not seeking patent protection in favor of its opposite, trade secret protection. Hence, the formula for Coca-Cola is considered the ultimate trade secret. See §§1.18, 3.7.

Economists often argue that in markets with many substitute goods, barriers are best obtained through control of channels of distribution and establishment of brand loyalty. In markets such as the soft-drink industry, the form of intellectual property that is most important to companies such as Coca-Cola shifts in priority. Trademark protection becomes of great importance. The market value of Coca-Cola, the company, is weighted heavily towards the value of its brand, which includes the trademark. If that is where the value lies, that is where counsel should start an IP due diligence examination. Note that for the entire soft-drink industry, brand recognition may not be equally important to all market participants. Some compete with products that are not easily substituted.

The first step in planning a due diligence investigation is therefore to make a formal inquiry of the nature of the industry. See generally §4.5. Counsel should ask, "What type of intellectual property is most important to this industry, and how important is it as an entry barrier when compared to other available entry barriers?" The answers will help determine how important IP due diligence is to a particular transaction, and will also help prioritize the type of intellectual property that should be the focus of the initial and most concentrated due diligence efforts. Further, it will help identify all the relevant types of intellectual property. For example, a due diligence examination would not stop at Coca-Cola's trademarks. Its trade secret formula is still very critical.

In addition, determining that the target industry is heavily focused on one particular type of intellectual property protection will enable counsel to resource the investigation with appropriate IP experts, *e.g.,* experts with the appropriate technical backgrounds for patent-intensive industries. Based on this information, counsel can develop a carefully crafted outline of what needs to be reviewed, and in what order. This will help ensure that counsel conducts a time- and cost-efficient and useful IP due diligence examination for the client.

Some important features of different types of IP-focused industries are discussed in §§4.16-4.19.

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§4.16 1. Patent-Intensive Industries

Patents are a clear barrier to entry. If a product is patented, all other things being equal, another party cannot make, use, offer for sale, sell, or import the same product without permission of the patent holder. This is fundamental economic monopoly power. But the question of whether a patent is appropriate and how effective it is as a barrier requires further inquiry into the economics of the industry. In some industries, such as the pharmaceutical industry, patent rights define market share. In others, such as consumer goods for which there are many substitutes, patents are generally not as important, or else design patents are more important than utility patents. Markets with many substitute products are often mature, and the scope of patent claims tends to mirror the scope of market share (and vice versa).

Regardless of the industry, in conducting IP due diligence it is a good idea to inquire how broad is the monopoly power exercised by market participants. How many players are there? Are there many small players or a few large ones? Often this is dictated by the scope of patent protection. For example, some industries are characterized by narrow patents that provide very narrow protection, and there are therefore many market participants, each with a small measure of monopoly power. In other industries, a wide patent net may be cast, and there are few participants. If the industry requires large economies of scale to manufacture products, or if it is heavily regulated, it may be an oligopoly, such as the pharmaceutical industry or the oil and gas industry.

How an industry competes will enable counsel to understand how important patent rights are, if that is the intellectual property protection of choice. It will also help in understanding the potential antitrust implications of the transaction. Often, either the client or the target can provide this information. At times, however, counsel will not have the benefit of this information at the outset of the transaction.

Armed with an understanding of the type of IP protection that is most important or useful to the target industry, especially when compared with other entry barriers, counsel can plan a reasonable investigation of a particular type of IP. For example, if the industry is an oligopoly that heavily relies on patent protection, it is likely that there are particular patents—or perhaps even just one patent—that could put a market participant (the diligence target) out of business if compromised. Counsel should expect to review the patent not only to confirm that it covers the product, but also to confirm that it is of sufficient breadth to preclude competition by products similar, but not identical, to the marketed product and to determine how long the patent will be in force. Key points of concern would be how strong the patent is, whether it can be challenged, and whether it is of sufficient scope to support the target's disclosures related to it and the target's economic projections that depend on the patent's remaining a significant barrier to entry.

In another transaction, however, counsel may find that individual patent protection is narrow, and counsel's focus may change to a family of patents or to different aspects of patent protection. Counsel should also be on the alert for industries or industry segments where there is a lot of patent litigation, as market participants fight for small pockets of market share in a crowded market.

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§4.17 2. Copyright-Intensive Industries

Copyright-intensive industries include the publishing, music, and motion picture industries. In these industries, published works in tangible media constitute the industry products. Because of the nature of copyright law, which affords protection the moment a work is "fixed in any tangible medium of expression" (see 17 USC §102(a)), if a copyrighted work is copied by a competitor and sold on the open market, the copyright owner loses a sale and its market share is compromised incrementally. Litigation in these industries is common, based on copyright infringement, unfair competition, and other causes of action.

If counsel understands how copyrights preserve market share, counsel will know where to focus due diligence efforts. In copyright-intensive industries, what is important is not so much that there is a copyright—copyrights are easy to obtain—but rather how copyrights are enforced: How are third parties put on notice that the target company will assert its copyright if infringed? Answers to these questions will dictate where to focus copyright diligence.

Software—source code and even object code—is also subject to copyright protection. But in the software industry, thanks to the Federal Circuit's decision in *State Street Bank & Trust Co. v Signature Fin. Group* (1998) 149 F3d 1368, cert denied (1999) 525 US 1093, patent protection became easier to obtain through so-called business method patents, until a more recent decision in *In re Bilski* (Fed Cir 2008) 545 F3d 943, cert granted sub nom *Bilski v Doll* (2009) ___ US ___, 174 L Ed 2d 246, 129 S Ct 2735, rejected *State Street*'s test for patentability of business methods. Although the Federal Circuit in *Bilski* did not expressly invalidate business method patents nor eliminate software patents altogether, based on the U.S. Supreme Court's reaction to *Bilski*, these patents will be much more difficult to obtain in the future. Whether the copyright or the patent is more important for a software company will depend on many of the same fundamental issues discussed in §4.16.

Another fundamental question is what is the product life cycle of the software product? If it is 6 months, does a 20-year patent have value? If the software benefits from a legacy, *i.e.*, a multi-generational platform that carries over from version to version, the software is more likely to benefit from patent protection. In the context of software IP due diligence, it is highly important to determine whether the fact that the target has no patent protection for its software products constitutes a problem.

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§4.18 3. Other IP-Focused Industries

Consumer goods are often sold in markets with many substitute products. Consider the Coca-Cola example discussed in §4.15. Brand recognition is a significant aspect of the competitive landscape and can be central to developing "mental" monopoly power, *i.e.*, when consumer preference and brand loyalty are disassociated from the fact that there are many substitute products. True monopoly power occurs when there are no substitutes and market participants can realize extraordinary returns (high margins). Branding is one way to obtain "mental" monopoly power, and one way to protect a brand is through strong trademark protection. In these cases, the importance of due diligence review of trademarks increases, as does the scope and depth of review.

Many industries depend on other forms of intellectual property, such as trade secrets or performance rights, but the fundamental questions are similar. Once the most relevant type of IP is identified, counsel can prioritize and resource the due diligence investigation in an informed way.

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§4.19 4. Heavily Outsourced Industries

From an intellectual property perspective, outsourcing is important to consider, because it can involve the movement of IP rights from the diligence target to a third party. It is important to determine whether the target is part of an industry where outsourcing is common. Everything from research and development, to manufacturing, marketing, commercialization, sales, and customer service and support can be outsourced, and all of these functions can involve movement of some type of IP. For example, if a target company is a biotechnology company that outsources its manufacturing of drug substance, it will need to transfer its intellectual property concerning manufacturing processes to the manufacturer. Often, manufacturing IP is not patented but is subject to trade secret protection. Consequently, sharing it with a third party may be a sensitive issue, and IP diligence counsel should review the steps taken by the target to protect the trade secrets when manufacturing has been outsourced.

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§4.20 B. Scope of Diligence Review

With the right industry context, counsel can frame the scope of review of a particular form of intellectual property, armed with a systematic plan for adequate, efficient, and useful intellectual property due diligence. See generally §§4.7-4.9. The scope of review appropriate to different types of intellectual property is discussed in §§4.21-4.36.

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§4.21 1. Patents

In general, patent due diligence should be left to patent experts. But even expert patent attorneys do not always know exactly how to conduct a due diligence examination. The core practice areas of patent attorneys are typically drafting and prosecuting patent applications or drafting freedom-to-operate and noninfringement opinions. In each of these practice areas, patent attorneys review patents, but the standard of review is different from the standard of review appropriate for a due diligence investigation, which is dictated by other factors. For example, as noted in §4.14, a patent drafter will review the prior art, *i.e.,* prior patents or publications of either the filing party or of third parties, to determine whether the invention sought to be patented is patentable when compared to the prior art. Patent drafters have a duty of candor to the patent office to disclose all material prior art of which they are aware. Similarly, as noted in §4.14, patent litigators conduct claims construction analysis of the claims of the patent at issue. But the standards that guide these inquiries differ from the standards applicable in a due diligence investigation, *e.g.,* for a merger or acquisition.

Often, a patent attorney asked to conduct due diligence will not receive guidance concerning the scope of review, and may proceed to review a patent as he or she would in the normal course of his or her practice—but this may be inefficient and may not accomplish the goals of a due diligence investigation. Even in industries where patent protection is not so critical as to warrant extensive patent due diligence, it is often advisable to conduct some measure of diligence to confirm proper ownership and assignment of patents as well as upkeep and maintenance.

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§4.22 a. Appropriate Scope of Review

The scope of patent review should be dictated by the answers to the questions in §§4.15-4.16 and the matters below regarding the nature of the target industry, the particular market participant, and the transaction.

If the target has one or more key products that generate significant revenue, the review should encompass, among other things, the following actions and objectives:

- Reviewing carefully the products and the components of those products to a level of technical detail by a technical expert sufficient to identify what components are most important from a proprietary standpoint.

EXAMPLE: Chemicals companies manufacture commodity or specialty chemicals for many different uses, including fabrics, textiles, and automobiles. Such companies may compete on price or on quality. Often, the key barriers to entry are a combination of economies of scale and control over supply channels. Although patents are important in the chemicals industry, process patents tend to be more important than composition-of-matter patents. Particular chemicals may not be subject to much protection, often because they have been in the public domain for a long time, but proprietary and cost-effective methods to manufacture them may be subject to substantial patent or trade secret protection.

- Understanding the target's basic patent strategy through interviews with the target and its patent counsel. Sometimes this may not be possible, *e.g.,* in leveraged buyouts when the client is a potential private equity bidder.
- Obtaining a detailed list or schedule (a docket) of the target's patents and patent applications, including patent, application, and publication numbers, foreign filing numbers and jurisdictions, filing dates, assignees, licensees, inventors, what products and technology or product platforms they relate to, and the status of prosecution or maintenance. A sample patent schedule is presented in §1.30.
- Identifying the key patents that cover the target's key products or product areas that generate the most current or expected revenue, whether on the basis of gross sales or on an EBITDA basis. (EBITDA is an acronym for earnings before interest, taxes, depreciation, and amortization).
- Determining that the target owns, or has the appropriate license to, the patents needed to operate its business, *i.e.,* that the target has perfected its material intellectual property rights:
- By looking at the face of a patent to ensure that the target is the assignee.
- By obtaining records from the patent and trademark office to confirm that a proper assignment was executed.
- By investigating whether there have been subsequent assignments of the patent following issuance.
- By confirming that the target requires employees to execute proprietary inventions and disclosure agreements that obligate them to assign rights to patents to the target.
- By inquiring whether there may be other parties who can claim to be owners or co-owners of the patent.
- By inquiring whether title to patents is encumbered by bank liens, security interests (see chap 9), third party claims, or license grants as collateral, by license restrictions, by reserved rights, by options, or by other encumbrances.
- If the patents are not owned by the target, by reviewing in-license agreements and confirming the above as to the licensor, and identifying royalty and other obligations that may impact the target's financial statements.
- Determining that the patent(s) cover the target's product:
- By reviewing the patent specification to ensure that the product, its use, and its utility is properly described and enabled and that the best mode (*i.e.,* the best or most useful version of the invention) is disclosed.
- By reviewing patent claims to ensure that there are claims appropriate for the type of patent protection sought within the context of the target industry, for example:
    - Composition-of-matter claims that cover the "thing," *i.e.,* the product, the molecule, the device, the widget;
    - Method-of-use claims that cover the particular use of the product;

    - Method-of-making claims that cover its manufacture;
    - Straight process claims if the product is a method or process; and
    - Claims similar to those above that are broader and could therefore cover other versions of the product or other uses. Such claims help cast a wider net to prevent competitors from encroaching on the target's market.
- By reviewing related patents and claims to ensure that there are "genus" claims, *i.e.,* coverage of products that are not identical to the product sold, but that are sufficiently related to create a broader footprint of patent rights, so that the product can be refined and improved and the improvements or refinements can benefit from claiming the priority of earlier patents.
- Determining whether any pending material patent applications are likely to issue:
- By examining the prosecution history.
- By examining the prosecution history of parent applications or related applications if an earlier "divisional" application was filed as a consequence of a "restriction" requirement from a common parent application.

NOTE: When the patent office determines that there is more than one invention claimed in a patent application, it will issue a "restriction" requirement. The applicant will then divide the inventions into two or more applications, thus creating a divisional application.

- Evaluating the importance of foreign patents to the target, learning what jurisdictions are involved, and making inquiries similar to those described above concerning foreign patent protection. These are very transaction-specific, industry-specific, and even market- or product-specific questions.
- Making a detailed inquiry into the target's freedom to operate (FTO). For further information on FTO analysis, see §4.23

NOTE: In some cases, *e.g.,* in certain M&A transactions, it may be appropriate and advisable to conduct a patentability analysis to provide a measure of likelihood that the target's patent applications will issue, or concerning the ultimate scope of pending patent claims. Because of the preponderance of evidence standard for patentability determinations (see *Total Containment Inc. v Buffalo Envt'l Prods. Corp.* (ED Va 1995) 35 USPQ2d 1385, 1393), however, in the author's opinion, a patentability analysis should be performed only if requested by the client and then only by patent attorneys with active patent prosecution practices.

- Learning who the key competitors are and whether they favor aggressive litigation for enforcement or cross-licensing, patent pools, or other strategies.
- Determining whether, in any jurisdictions, there are any ongoing or threatened:
- Litigation proceedings,
- Oppositions, or

NOTE: Oppositions are proceedings that take place in certain foreign countries. Just before a patent issues, it is published for potential opposition by third parties regarding whether it should issue. Such proceedings are often expensive to defend and very similar to patent litigation in the United States.

- Interferences.

NOTE: An interference is another type of expensive quasi-litigation proceeding that takes place before the U.S. Patent and Trademark Office (PTO)'s Board of Patent Appeals and Interferences (see 35 USC §102(g)). The purpose of the proceeding is to determine which party was the first to invent a particular invention and thus would be entitled to priority over the other party's application. Interferences can be provoked when two patent applications by two parties describe the same invention. Often the PTO initiates the proceeding. Interferences can also be provoked between a pending patent and an issued patent, but never between two issued patents.

- Determining whether (1) the target has received any letters alleging infringement by the target of a third party patent, *i.e.,* letters that permit the target to seek declaratory relief in federal court and thereby take an offensive stance as a defendant in patent litigation, or (2) any third party claims of infringement by the target have been made, orally or otherwise.
- Learning whether the target has received letters offering licenses to third party patents, and whether the target

has sent any such letters to third parties.

The foregoing list is not exclusive, and depending on the industry, the transaction, client expectations, and relevant legal standards, one or another of the foregoing action items may be more important than others. For further discussion, see the descriptions of individual transactions in §§4.51-4.71.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.23 b. Freedom to Operate (FTO) Analysis

§4.23 b. Freedom to Operate (FTO) Analysis

A freedom to operate (FTO) analysis, also called an FTO search or a product clearance search, is essentially a determination of a company's freedom to compete in a relevant market in the context of third party intellectual property entry barriers. An FTO analysis asks whether there are third parties who own, *e.g.*, patents that may be asserted against a market participant (the target). It is a complex process that involves sophisticated searches of databases and disclosures in scientific literature, *e.g.,* for the chemistry and biology of biotechnology or pharmaceutical products, or the mechanical aspects of durable products.

An FTO analysis takes into account the nature of the patent holder (aggressive litigant, passive market participant, or patent troll) and the strength of its patent position. That strength is evaluated by determining first whether the target's product may infringe one or more third party patents, and then whether the third party patent itself is valid or whether it can be attacked, weakened, or subverted.

Although FTO is a term commonly used in the context of intellectual property due diligence, many clients—and even many patent attorneys—do not fully understand what is meant by an FTO analysis, or may have a different understanding than lead diligence counsel. Properly used, an FTO analysis is very expensive and time-consuming and can cost upwards of $150,000 to perform. In a patent-intensive industry, a full FTO analysis is best handled by patent attorneys with a regular patent prosecution practice. Often, lead counsel will need to review FTO issues identified in due diligence or discussions with the parties, but this is different from a true FTO analysis. Counsel should explain the precise scope of review carefully to enable the client to determine whether that review will be sufficient and whether qualified patent counsel should be engaged to conduct a full FTO analysis.

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§4.24 (1) Noninfringement or Invalidity Opinions

Often, an FTO analysis will lead to a decision to engage outside patent counsel to render noninfringement or invalidity opinions on select third party patents identified in an FTO search. If the FTO reveals concern that the target's product may be accused of infringing a third party patent, the target is now on notice of that patent. If the target continues to sell the product and is sued for patent infringement by the patent owner years later, the target may be exposed to treble damages for willful infringement because it was on notice of the patent as a consequence of the FTO. To help avoid such treble damage liability, the target may commission a noninfringement opinion from patent counsel with experience in preparing such opinions that sets forth a reasonable basis to conclude that the target's product does not infringe the patent. Alternatively, if the product does infringe, the target may request experienced patent counsel to render an invalidity opinion that provides a reasonable basis to conclude that the patent at issue is not valid.

Noninfringement or invalidity opinions, if properly prepared, reasonably exculpatory, and produced in litigation, can prevent an award of treble damages for willful infringement even if the target is held to infringe the patent anyway and the patent's validity is upheld. It should be noted, however, that in light of *In re Seagate Technology, LLC* (Fed Cir 2007) 497 F3d 1360, cert denied sub nom *Convolve, Inc. v Seagate Technology, LLC* (2008) ___ US ___, 128 S Ct 1445, 170 L Ed 2d 275, such formal opinions may no longer be necessary to avoid willful infringement. *Seagate* effectively raised the bar on the willfulness standard to one of objective recklessness. Consequently, such opinions are now less common in diligence investigations, and inquiries surrounding freedom to operate with respect to key third party patents will require more contextual analysis rather than evaluation of a non-infringement or invalidity opinion.

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§4.25 (2) Need for Expertise

Decisions concerning whether to conduct an FTO analysis, as well as decisions concerning whether to engage patent counsel to render noninfringement or invalidity opinions, are best left to the target company based on the advice of sophisticated patent attorneys experienced in FTO matters and patent litigation. Not all patent attorneys have a practice that includes FTO analysis and opinion drafting, and not all patent firms do patent litigation; these are very specialized aspects of patent practice. In general, IP diligence counsel should not plan to undertake an independent FTO analysis or to render noninfringement and invalidity opinions unless specifically requested by the client after the risks of such analysis are properly explained and unless fully qualified to do so. In the IP diligence context, FTOs and opinions are rarely done by IP diligence counsel. An FTO analysis may already have been conducted, and opinions may already have been rendered by experts for the target. If IP diligence counsel's opinion is at odds with those already in existence, the target's own opinion may be more easily attacked by the third party that owns the patent described in the opinion. Consequently, IP diligence counsel could actually harm the target's patent position. Once again, to borrow from the Hippocratic Oath, diligence counsel should "first, do no harm."

In addition, the standards used to evaluate whether noninfringement or invalidity opinions may be successfully asserted as affirmative defenses to willful infringement dictate that only patent counsel with significant experience preparing noninfringement and invalidity opinions should undertake to write them. To borrow from the Hippocratic Oath again, counsel should "avoid attempting to do things that other specialists can do better." Nonetheless, it is appropriate and desirable for lead IP diligence counsel to verify the substance of the FTO analysis and expert opinions and, if appropriate, to challenge the conclusions, as well as to confirm that opinions were prepared by competent counsel and that the facts and circumstances surrounding the opinions support a reasonable basis for their conclusions. After *Seagate* (see §4.24), the facts and circumstances are more often the only focus in the absence of a underlying opinion.

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§4.26 (3) Privilege Issues

In many cases, counsel for the target will refuse to provide IP diligence counsel with copies of FTO, noninfringement, and invalidity opinions, citing a refusal to waive the attorney-client privilege. The parties may argue whether such disclosure would waive the privilege or whether the disclosure would be covered by the common interest doctrine (see, *e.g., Synopsys, Inc. v Ricoh Co*. (ND Cal 2006) 2006 US Dist Lexis 64270) with or without a common interest agreement in place. The parties may also debate recent case law on adverse inference jury instructions concerning an alleged infringer's failure or refusal to produce an exculpatory opinion in litigation. See *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GMBH v Dana Corp.* (Fed Cir 2004) 383 F3d 1337. However, *In re Seagate Technology, LLC* (Fed Cir 2007) 497 F3d 1360, cert denied sub nom *Convolve, Inc. v Seagate Technology, LLC* (2008) ___ US ___, 128 S Ct 1445, 170 L Ed 2d 275, held that assertion of an advice of counsel defense to willful infringement and disclosure of the opinion will not waive the attorney-client privilege. The consequence of *Seagate* in this context is that the target will be less likely to disclose such an opinion, because any argument that diligence counsel historically made that the privilege will be waived eventually no longer applies. Common practice is to verify the conclusions made in the opinions by inquiring about the facts and circumstances without reviewing the opinions themselves. Diligence counsel may review the third party patents to which the opinions relate and interview the patent counsel who prepared them. Although the opinion itself may be protected by the attorney-client privilege, the facts that underlie it are not.

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2. Copyrights (Including Website Issues)

§4.27 a. Generally

Whether a due diligence examination of a target's copyrights requires a copyright specialist often turns on whether copyrights are the most important aspect of the target's intellectual property protection. If so, industry copyright experts are often needed. If not, many intellectual property attorneys have sufficient knowledge of copyright law to conduct basic copyright due diligence.

Practically speaking, it is not always reasonable to require a target to provide a list of all its copyrights, because copyrights exist automatically once a work is fixed in a tangible medium. See 17 USC §102(a). Asking for a list of registered copyrights may be more appropriate, together with those unregistered copyrights that the target believes are material to its business, with the understanding that registration is not required to obtain copyright protection but is a prerequisite for an infringement suit. See 17 USC §411(a).

NOTE: Copyright due diligence generally encompasses a review of issues concerning the target's website. For a checklist of matters that should be included in a due diligence investigation of an Internet website, see Internet Law and Practice in California §22.13 (Cal CEB 2004).

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.28 b. Appropriate Scope of Review

§4.28 b. Appropriate Scope of Review

The scope of copyright diligence will often include the following information about registered copyrights:

- The target's copyright procurement and enforcement strategy.
- The nature of the copyright.
- The target's use of appropriate copyright notices, particularly for pre-1989 copyrights.

NOTE: Before 1989, federal copyright law required that all copies of copyrighted works contain a visible notice of copyright ownership in order to enforce the copyright and avoid dedication to the public. Although a notice is no longer required as of March 1, 1989, as a result of the harmonization of U.S copyright laws with the Berne Convention (see Berne Convention Implementation Act of 1988, codified at 17 USC §101 note), notices are still recommended to support claims of willful copyright infringement.

- Identity of the authors.
- Proof of title by assignment or otherwise, such as "work for hire" agreements, and confirmation of the chain of title to the copyright on the records of the U.S. Copyright Office.
- Registration information, including when and where issued and the registration number.
- When and where the work was first published.
- Whether there are any third parties with claims to the copyright.
- Whether there has been a subsequent purchaser in interest of the copyright.
- Whether there has been a transfer of rights through an assignment or license, and whether the transfer has been recorded with the U.S. Copyright Office to protect the new holder from a subsequent bona fide purchaser without notice.
- Whether there are encumbrances, either contractually or through a filing in the U.S. Copyright Office or state UCC records.
- Whether the target has sent any cease-and-desist letters to third parties or threatened or initiated litigation with respect to its copyrights.
- Whether the target is currently involved in any copyright disputes or litigation.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/ 3. Trademarks (Including Domain Names)/§4.29 a. Generally

3. Trademarks (Including Domain Names)

§4.29 a. Generally

Trademarks may include brand names, domain names, and company names. In theory, common law trademark protection can be obtained, at least locally, through some demonstration of actual prior use in commerce. See, *e.g., Tally-Ho, Inc. v Coast Community College Dist*. (11th Cir 1989) 889 F2d 1018, 1022 (Florida law). Broader and more reliable protection is available by registering the trademark federally (see 15 USC §1051) or with the state where a company does business (in California, see Bus & P C §14200-14272). Before issuance of a federal trademark registration, the trademark owner may use the symbol to put third parties on notice of its assertion of common law trademark rights; after federal registration, the ® symbol may be used. See 15 USC §1111. If trademarks are important to a company, it will seek federal registration.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.30 b. Appropriate Scope of Review

§4.30 b. Appropriate Scope of Review

The nature of the target industry and the transaction will indicate which marks are most important, in what jurisdictions, and for what uses. The scope of trademark diligence will depend on the importance of trademarks to the target, the industry, and the transaction (*i.e.,* whether the trademarks are included in the purchase). Usually, trademark diligence will include:

- Obtaining a list of all registered and common law trademarks and Internet domain names, including registration numbers, issue dates, and jurisdictions, along with key foreign trademark rights.
- Learning the status of key trademarks, including whether they are registered on the principal register (see 15 USC §1052(a)), whether there is a bona fide intent to use a mark (see 15 USC §1052(b)-(d)), whether maintenance fees have been paid and updating affidavits filed, and whether a mark is currently in use in commerce in each class in which it is registered or whether it has been abandoned.
- Learning the status of the target's domain names. In general, ownership of a domain name is obtained from the domain name registrar for a certain period and must be renewed regularly or else ownership can be lost. See generally Internet Law and Practice in California §§3.1-3.10 (Cal CEB 2004).
- Ascertaining the trademark classification numbers, to ensure that the class registrations match the use of the trademarks.
- Obtaining proof of ownership or license, including chain of title searches and confirmation of appropriate registration or proper recordation of assignments to protect against subsequent bona fide purchasers for value without notice.
- Verifying appropriate and consistent use of trademark notices.
- Determining whether there are any encumbrances, including bank liens and other security interests (filed with the PTO or applicable state offices), options, hold-back rights, license restrictions, contractual rights, and the like.
- Reviewing any trademark searches and product clearance searches (FTO searches) conducted by or on behalf of the target. If a trademark is central to the transaction, counsel should conduct or arrange for a formal trademark search on the mark.
- In some cases, *e.g.,* when product and company branding are important to the particular industry or market, making an evaluation of the strength of the mark, such as level of distinctive meaning (*e.g.,* coined or fanciful, arbitrary, suggestive, descriptive, generic) and the nature of registration (whether any font of the mark infringes, whether it was registered only in a particular font, or whether only the logo is protected).
- Learning the target's brand strategy.
- Learning the target's trademark enforcement strategy and practice.
- Determining whether the target has sent any cease-and-desist letters or has threatened or initiated any litigation to enforce its trademarks.
- Learning the target's trademark antidilution strategy and practice.
- Determining whether the target has licensed marks to third parties, with particular attention to the nature of the licenses. Are they naked licenses? Do they contain quality control provisions to ensure that there is no dilution or damage to the reputation of the target?
- Learning whether the target has been or is currently involved in any trademark litigation, whether any claims have been made or threatened against the target, or whether the target has made or threatened any claims.

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4. Trade Secrets

§4.31 a. What Are Trade Secrets?

It is safe to assume that the target company will have trade secrets, such as customer lists, marketing plans, development plans, software specifications, chemical processes, source code, designs, drawings, and manufacturing technology. Whether these trade secrets are material to the transaction will depend on their nature, the industry, and the client.

Trade secret law is based on state enactments of the Uniform Trade Secret Act (see, *e.g.,* CC §§3426-3426.11) and common law protections. See generally Trade Secrets Practice in California (2d ed Cal CEB 1996). If trade secrets are a key aspect of the IP due diligence investigation, the principal focus of review will be not only to identify the trade secrets of the target, but also to ensure that the target complies with the legal requirements for establishing trade secret protection, so that its trade secrets are enforceable. Under California law, an enforceable trade secret is information that (1) is not generally known in the industry, to the public, or to others who can realize economic value from its disclosure or use, (2) has independent economic value, whether actual or potential, that derives from its secrecy, and (3) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. CC §3426.1(d). In jurisdictions outside of California that have adopted the Uniform Trade Secrets Act, there is an additional requirement that the trade secret cannot be easily reverse-engineered. Although the Uniform Trade Secrets Act contains a requirement that the trade secret not be "readily ascertainable" and thus not be easily reverse-engineered, the California statute does not contain such a requirement. See, *e.g., ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 21, 286 CR 518.

Trade secrets are, in effect, the polar opposite of patents. Patents gain protection by their public disclosure in exchange for statutory exclusivity for a period of time. (Since June 8, 1995, the period has been 20 years from the filing of the patent application. See 35 USC §154(a)(2).) The moment a patent expires, the invention is dedicated to the public. Trade secrets, however, gain protection by remaining secret and undisclosed to the public, and their status as trade secrets is retained in perpetuity, unless or until they become publicly known. The moment a trade secret becomes publicly known it is immediately dedicated to the public.

Unlike patents, trade secrets are not enforced by treating them as property. Trade secret misappropriation is litigated more as a violation by the misappropriating party of a duty of confidentiality that it had to the owner, either expressly or by implication. Thus, to meet the legal standard for trade secret protection, a company must ensure that all persons with access to the company's trade secrets understand what are trade secrets and that they have a duty to maintain their secrecy. Due diligence counsel must therefore identify the individuals (including employees, independent contractors, and others) who have a duty to maintain the secrecy of the target's trade secrets, and determine whether the target has been sufficiently diligent in identifying its trade secrets and maintaining their secrecy.

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§4.32 b. Appropriate Scope of Review

In this context, trade secret due diligence often involves:

- Reviewing the target's trade secret policies, including e-mail and electronic document policies, procedures, notices to employees, programs, and other strategies to protect confidentiality. A robust trade secret program will include employment policies, provisions in employee handbooks and agreements, exit letters, letters to third parties who hire former employees, "need to know" restrictions on disclosures to employees, and special procedures for handling trade secrets beyond what is used for ordinary confidential information.
- Reviewing a target's patent strategy, because patents are a frequent alternative to trade secret protection and the target's patent strategy should provide background on what the company would consider a trade secret.
- Identifying key trade secrets of the target. This can be difficult. In the M&A context, to avoid a fishing expedition by the buyer, the target will often resist disclosure of important trade secrets until late in the transaction, after it is confident that the transaction will proceed to closing.
- Identifying licenses that grant rights to trade secrets.
- Reviewing confidentiality agreements that include disclosure of trade secrets. If trade secrets are disclosed under a confidentiality agreement, is the obligation of the recipient to maintain the trade secret confidential bundled with other general confidential information and limited in time? This raises a red flag, because it means that the party can disclose the trade secret at some future time, at which point it would no longer be a trade secret. Furthermore, because many such agreements do not specify in sufficient detail the confidential information being disclosed, it is often difficult for counsel to determine whether such information includes trade secrets.
- Determining whether the target has been or is currently involved in any trade secret litigation, and whether any misappropriation claims have been made or threatened against the target or whether it has made or threatened any misappropriation claims.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/ 5. Know-How/§4.33 a. As Confidential Information

5. Know-How

§4.33 a. As Confidential Information

Know-how may include trade secrets, but in this discussion the term is used to refer to confidential information of the target that does not qualify as a trade secret. Whether or not it has trade secret status, certain confidential information of the target may be critical to the transaction. If the target fails to obtain or preserve trade secret status for the information, its confidentiality may still be protected under contract law. In this case, the task is simply to review the agreements that protect confidential information of the target, including:

- Confidentiality or nondisclosure agreements;
- Employee proprietary information and invention agreements;
- Consulting agreements;
- Confidentiality provisions of commercial agreements;
- Policies regarding confidential information;
- E-mail policies and practices;
- Document retention policies and practices; and
- Marking procedures for confidential paper and electronic documents and related notices.

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§4.34 b. Appropriate Scope of Review

Any review of these documents for confidentiality issues should include review and consideration of the following:

- How the information to be disclosed is defined, in the context of exposure to the target company. For example, if the definition of confidential information is broad and vague, essentially any information provided by the disclosing party would be considered confidential. If the target company is the recipient and a competitor of the disclosing party, however, this may be problematic. Often the recipient will want a narrow definition of confidential information, setting forth precisely what is to be disclosed, in order to minimize potential contamination of the information disclosed by other confidential information of the disclosing party. If the target is the disclosing party, however, a broad, vague definition may be more advantageous to it. See, *e.g.,* the definition of "Information" in Section 2.2 of the form of confidentiality agreement in §8.3.
- To whom the information may be disclosed by the recipient. A recipient's ability to disclose the information to third parties may be problematic if the agreement does not carefully identify which third parties and under what conditions (*e.g.,* that any disclosure must be subject to similar confidentiality restrictions). Similarly, if the target is the disclosing party and the information includes trade secrets or otherwise valuable confidential information, restrictions with respect to distribution of the information to recipient employees on a "need to know" basis are important.
- The term of disclosure. Agreements with open-ended disclosure terms may be problematic and expose a recipient to risk every time there is any communication with the disclosing party, even years after their original discussions. If the target company is the recipient, it will want to have a finite time period during which the disclosing party may provide it with information under the agreement.
- The term of the confidentially obligations. Many companies simply follow a common practice on the term of the obligation, such as 5 or 7 years. Counsel reviewing the agreements should be cognizant of the nature of the information (to the extent it is adequately described) and then consider an appropriate period for the confidentiality obligation in relation to the useful life of the information. For example, if the target is a pharmaceutical company that has disclosed the molecular formula and process for manufacture of its key early-stage product to another company, a term of 3 or 5 years may not be adequate because it will take 10 or more years for that product to make it to market. Consequently, the useful life of the information is longer than 3 or 5 years. Conversely, 3 years may be entirely adequate for software source code that has a useful life of 3 years or less.
- Exceptions to confidentiality obligations. These boilerplate provisions (see, *e.g.,* the exclusions from the definition of "Information" in Section 2.2 of the form of confidentiality agreement in §8.3) provide for situations where disclosure of confidential information does not breach the agreement. Some of these provisions may be too vague or broad in scope and may be an easy way for the recipient to bleed information out of the disclosing party.
- Asking the target about its policies and practices with respect to confidential information in the context of such agreements. For example, if an agreement has a marking requirement (*i.e.,* that the disclosing party mark it confidential) or requires that oral disclosure be followed up with written verification of that disclosure, does the target have written polices providing for this? Has the target been following those policies or otherwise complying with the terms of the agreements?

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/ 6. Intellectual Property Agreements/§4.35 a. Types of Agreements

6. Intellectual Property Agreements

§4.35 a. Types of Agreements

Any transfers or formal sharing of the target's key intellectual property rights are as important as the nature, scope, and strength of the IP itself. Intellectual property agreements are agreements that impact the target's rights to intellectual property in one way or another. Many different types of agreements can do so, and the types of agreements vary among industries. Licenses are one type; secured lending agreements are another. Common types of agreements from various industries that may need to be reviewed include:

- In-license agreements that give the target rights in key intellectual property, including licenses from academic and government institutions subject to the Bayh-Dole Act (35 USC §200) (see §8.26), under which the government retains certain rights to inventions;
- Out-license agreements of rights to key intellectual property to third parties;
- Research and development agreements, including Cooperative Research and Development Agreements (CRADAs) with research agencies and departments of the federal government pursuant to the Stevenson-Wydler Technology Innovation Act of 1980 (15 USC §§3701-3715), as amended by the Federal Technology Transfer Act of 1986 (Pub L 99-502, 100 Stat 1785);
- Confidentiality agreements;
- Proprietary inventions and disclosure agreements with employees;
- Consulting agreements;
- Work-for-hire agreements under federal copyright law;
- Manufacturing and supply agreements;
- Distribution agreements;
- Co-marketing and co-promotion agreements;
- Partnering, strategic alliance, collaboration, spin-out, and joint venture agreements;
- Litigation settlement agreements that provided for licenses or other intellectual property agreements;
- Software end-user licenses, including shrink-wrap and click-wrap agreements;
- Website content agreements;
- Publishing rights agreements;
- Likeness and name use rights agreements and similar agreements;
- Value added reseller (VAR) agreements;
- Original equipment manufacturing (OEM) agreements;
- Asset purchase agreements; and
- Financial agreements, such as secured transaction agreements, loans, and equity investments to determine the extent to which they encumber intellectual property.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.36 b. Appropriate Scope of Review

§4.36 b. Appropriate Scope of Review

When reviewing an intellectual property agreement, asking certain questions will help counsel focus on those portions of the agreements that are most critical to the particular transaction, and the nature of the target industry will also influence the scope of review. For example, in the context of M&A transactions, assignment and change of control provisions may be extremely important, depending on the structure of the deal. See §§3.44, 7.14-7.20. Chain of title is also critical in M&A. In general, the following questions may be relevant:

- Is the agreement currently in force? What is its term? Has it been amended? If so, have all amendments been furnished to the reviewer? Are there any side letter agreements relating to the main agreement?
- What particular intellectual property rights of the target are covered by the agreement? Are the relevant patents, trademarks, and other IP rights properly scheduled?
- What is the exact nature of the transfer? For licenses, what is the scope of its field, territory, and term, and what are the permitted activities (*e.g.,* manufacturing, using, selling). Were rights assigned? What obligations to license or assign rights to intellectual property exist under the agreement? Is sublicensing permitted? Is further sublicensing permitted? Should it be permitted?
- Is the technology subject to license or transfer to a foreign jurisdiction subject to U.S. export control restrictions? This can be a red flag, and the Export Administration Regulations (EAR) (15 CFR pts 730-774) should be consulted.
- What events can cause the target to lose rights to the intellectual property? What are the consequences to the IP if the agreement is breached? What happens if certain conditions are not met, such as diligence, reporting requirements, execution of certain documents, and performance of covenants?
- Does the target have reversionary rights to the intellectual property after it licenses or otherwise transfers the IP? What events trigger a reversion?
- What is the potential impact on ongoing revenue from a transfer of intellectual property rights from the transfer agreement itself or from contingencies that may arise under the agreement? What are the royalty obligations, license fees, milestone and other contingent payments, and termination fees?
- If reviewing a manufacturing and supply agreement, is the agreement for a sole-source supplier? If so, does it contain an escrow provision in case the other party cannot meet its supply obligations?
- Are there any rights in favor of one party to the agreement, such as most-favored-nations clauses?
- What will the impact be on the agreement in the case of an asset sale, or a merger or acquisition? Are there restrictions against assignment? Are there change of control provisions? For example, in an M&A transaction, the structure of the deal will implicate anti-assignment and change of control provisions differently. If the transaction is structured as a reverse triangular merger, where the target continues as an ongoing legal entity that is a subsidiary of the buyer, agreements may not need to be assigned because the target company continues to be the primary obligor under the agreements. See §§3.44, 7.19. In an asset purchase of substantially all the assets to which an agreement relates, assignment may be permitted. In an asset sale of only a portion of the assets, assignment may not be permitted or may require written permission of the other party to the agreement.
- What are the limitations of liability for breach of the agreement, *e.g.,* relating to use or transfer of the intellectual property? What other liability protection does the target have, *e.g.,* concerning damages or survival of agreement provisions?
- Is the target in compliance with the agreement? Have there been, or are there, any disputes under the agreement?
- What are the diligence obligations under the agreement?
- Are there any exclusivity provisions?
- What indemnities does the target provide?
- What warranties does the target provide?

- Are there any antitrust concerns that may arise from the agreement? Is there patent misuse, *e.g.,* as a result of a license agreement? Or, *e.g*., is the royalty rate the same in a patent license after the patent expires?
- Are there any accounting concerns that may arise from the agreement? Although counsel may be focusing on IP issues, counsel may be the only person tasked with reviewing the agreement and may need to watch for non-IP issues that impact the transaction. For example, revenue recognition issues under the following accounting bulletins often impact transactions: Securities and Exchange Commission Staff Accounting Bulletin 101, 17 CFR Pt 211, and American Institute of Certified Public Accountants Statement of Position 97-2 (commonly referred to as SAB 101 and SOP 97-2, respectively); Emerging Issues Task Force (EITF) Abstract, Issue No. 00-21 (commonly referred to as EITF 00-21). Counsel may be asked to work with financial due diligence experts to help evaluate revenue recognition issues because of counsel's familiarity with industry practices.

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C. Reporting Results of Due Diligence

§4.37 1. Advisability of Written Work Product

Due diligence investigations can be extremely complex, time-consuming, and expensive. Preparing a formal written work product may be an important part of any substantial due diligence investigation, in order to have a concrete record of counsel's diligence efforts and analysis. In some cases, however, it may not be advisable or necessary to prepare a written work product. Whether a written work product is to be prepared is ultimately up to the client.

Generally, whether a written work product is appropriate will depend on

- The type of transaction;
- The client's wishes;
- General practice for similar transactions;
- The nature of the written work product; and
- The budget of time and money for the project.

In some cases, it is neither common nor necessary to produce a written work product for the client. Oral disclosure may be sufficient, and the project may be documented at best with attorney notes that may be subject to protection as attorney work product. In other cases, counsel may be asked to prepare a written document summarizing the due diligence findings. Fundamental to preparation of such a document is careful consideration of how it could be used in the future. This follows from the "first, do no harm" oath that due diligence counsel should take. See §4.14. For example, it is possible that the client might use the memo to assert a reliance-on-counsel defense (see §4.63). Could the client be compelled to produce the memo in litigation concerning this transaction, either through waiver of the attorney-client privilege or failure to successfully assert it? If so, would the memo hurt the client's case or help it?

In §§4.51-4.71, the nature of the work product is discussed in the context of each type of transaction.

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§4.38 2. Risk of Discovery in Litigation

It is always a good idea to prepare a memo under the assumption that it may be produced in litigation some day, and to prepare it in such a way as not to hurt the client. Because intellectual property due diligence can be complex, it will not be possible to capture every nuance of the investigation in a memo. As a consequence, the client will rely on a combination of the memo and oral discussions with counsel in the context of the client's own diligence or the diligence of other members of the transaction team. In the future, however, the memo may be read by a third party without the benefit of that context, and gaps left open may result in different conclusions about the adequacy and outcome of the due diligence conducted.

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§4.39 3. Risks of Including Legal Opinions

A key question is whether to put legal opinions in the memorandum. If the client is requesting a formal opinion (such as a negative 10b-5 assurance or a noninfringement opinion), that is one thing.

NOTE: A negative 10b-5 assurance is an opinion of counsel that a document or set of documents, such as a prospectus, registration statement, and related offering documents, do not contain any untrue statements of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. See Securities Exchange Act Rule 10b-5 (17 CFR §240.10b-5). Noninfringement opinions are discussed in §4.24.

But IP due diligence is often conducted outside the context of formal legal opinions, which are normally subject to specific conventions and standards of practice.

The client usually wants counsel's opinion on the intellectual property in the context of diligence goals, but how the opinion is communicated can be helpful or harmful. The client should be informed of all the identified risks and liabilities (including gaps) concerning the IP reviewed, so that the client can make informed decisions and comply with legal requirements for the transaction. Not all issues are black and white, however. Reasonable minds can differ over many issues, and counsel's job will be to identify those issues and provide logical positions when there is more than one choice. The concept of "reasonableness" is important. Counsel need not provide a firm answer to every question, but only a reasonable one given the alternatives.

The role of IP diligence counsel is to provide the client with the proper information so that the client can make decisions regarding particular risks or liabilities, and to advise the client whether the information available is sufficient for them to make a reasonable decision that complies with any applicable legal standards. Any written work product should not include conclusions or opinions unless the client has specifically requested them, and, depending on the transaction, it may be advisable to counsel the client against such a work product. For example, in some transactions, the client (*e.g.,* an underwriter in a public offering) may be able to rely on opinion of counsel, while in others the client (*e.g.,* an issuer in a public offering) may not. In the latter situation, counsel should provide the client with work product that enables the client to form its own opinion, *e.g.,* a memo summarizing the materials reviewed and their content, confirming basic facts, and disclosing particular matters discovered. The disclosures could range from items that are "smoking guns" to items that are simply atypical given the particular transaction or the particular industry.

If the client requests additional analysis or opinions, counsel may provide them orally, perhaps followed by a writing. Subject to the general qualification that the written work product is limited to the materials reviewed, the writing may confirm, *e.g.,* that the claims of a patent cover a product or that a trademark is properly registered. But stating that a patent is invalid, without more, is normally not appropriate. Similarly, stating that a contract clause means X, without more, is different than stating that the clause may mean either X or Y. Even in the latter case, counsel should exercise caution regarding how to document that observation. Counsel should seek to convey sufficient information for clients to make informed decisions and meet legal standards, yet to avoid creating a paper trail for a plaintiff's attorney that may not be protected by the attorney-client privilege. Ironically, not providing a detailed written work product may make it difficult to recollect the scope of the diligence review years later in litigation. Consequently, the question of whether to prepare or not to prepare written work product concerning IP due diligence itself involves a balancing of risks concerning the nature of its content.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.40 4. Time Required for Written Work Product

§4.40 4. Time Required for Written Work Product

Preparing a formal written memo for a diligence project can greatly extend the time required to complete the project, as well as its cost, which may double on account of the natural process of reverifiying content, filling diligence gaps, and formalizing review, summary, and analysis. In projects with tight budgets, these issues should be discussed with the client early in the course of the transaction.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.41 D. Risk Sharing; Representations, Warranties, and Disclosures

§4.41 D. Risk Sharing; Representations, Warranties, and Disclosures

Intellectual property transactions may be characterized as risk-sharing transactions. Risk sharing determines who bears the burden of uncertainties associated with the transaction and with the underlying intellectual property assets that are its focus. The allocation of risk between the parties is often a result of the nature of the transaction, the risk tolerance or aversion of the parties, their relative bargaining power, and the course of dealing in the industry.

For the buyer or investor, it is common practice to balance the scope of due diligence with the target's requirements to make certain representations and warranties in the documents for the transaction. The less due diligence performed, the more important the representations and warranties become. Moreover, an investor, buyer, or regulatory body may require the target to disclose material liabilities in disclosure schedules or the "risk factors" section of an offering memorandum. The reasons include:

- To enable the investor or buyer to assert a breach of contract claim against the target if a representation or disclosure is false or misleading.
- To enable third parties, such as stockholders, to be adequately informed of the risks associated with the target.
- To enable the target (and the investor, in many cases) to mitigate liability by having made full disclosure to the other parties.

Target companies also may perform due diligence, not only on their buyers or partners, but also on themselves, to support their representations and warranties, to properly qualify those representations and warranties with exceptions, to verify the need for and the adequacy of their disclosures, and to anticipate the outcome of diligence efforts of parties on the other side of the transaction.

Following is a list of assurances that IP diligence counsel may request, either in the form of representations and warranties in an agreement or in an intellectual property opinion from the issuer's IP counsel in the context of public offering due diligence—even if comprehensive IP due diligence has been conducted. These statements often end up with knowledge qualifiers, which may or may not be appropriate depending on the context. For example, if IP counsel only oversees or is otherwise not directly responsibility for patent prosecution, counsel may not have full access to information that would support any particular opinion absent a knowledge qualifier. Similarly, certain types of representations are difficult to make without a knowledge qualifier, such as a noninfringement representation regarding patent applications. Patent applications are not always publicly available, but even if publicly available, they may be unknown to IP counsel even after counsel has conducted an appropriate prior art search in the context of prosecution. The statements may also be subject to exceptions, and there should be full disclosure of any exceptions.

- The target owns the intellectual property rights or has the right to use them as contemplated by the transaction, and all such rights have been disclosed.
- The target's IP rights are not encumbered in any way.
- The target's exercise of its IP rights will not infringe any third party rights.
- No third party is infringing the target's IP rights.
- No third party is challenging the ownership or validity of the target's IP rights,
- The IP rights are not subject to any third party claim.
- All maintenance and other fees in respect of all registered IP rights owned or controlled by the target have been timely paid.
- The target and its IP counsel have met their duty-of-candor obligations under U.S. patent law.
- All agreements relating to the IP rights have been disclosed and are in full force and effect. No party to any such agreement is in breach thereof.
- The target has taken all steps necessary to preserve and protect its trade secrets as such.
- All of the target's employees have assigned their rights to any inventions or other IP made by them in the course of their employment.
- The target and its IP counsel have no reason to believe, after due inquiry and investigation, that the IP

disclosures in the transactional documents (*e.g.,* the registration statement, prospectus, or offering memorandum) contain (or contained) any untrue statement of a material fact or omit (or omitted) to state any material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. See 17 CFR §240.10b-5. This assurance is what is commonly referred to as a Rule 10b-5 negative assurance.

For further discussion of representations and warranties in transactions involving intellectual property, see chap 7.

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E. Process

§4.42 1. Generally

Sections 4.51-4.71 discuss the due diligence process for four different types of transactions. There are certain general considerations, however, that are important in every transaction in order to structure and manage the due diligence investigation effectively. Many transactions move very fast and have deadlines that are moving targets. It is not uncommon for a deadline to be advanced by a week or more at the last minute, or for surprises to crop up during the review process that require further investigation. Often, either the client or the circumstances of a particular transaction (*e.g.,* a registered direct offering) will not permit sufficient time or money to perform an exhaustive due diligence review of all of a company's intellectual property. If due diligence counsel begins the diligence process with careful planning and manages the process proactively, the potential for counsel to constitute a bottleneck in the transaction is decreased while the maximum benefit can be achieved. The tips in §§4.43-4.50 are intended to help counsel prepare for and complete the IP due diligence smoothly, on budget, and on time.

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2. Eight Habits of Highly Effective IP Due Diligence Counsel

§4.43 a. Get Involved Early

The sooner intellectual property counsel gets involved, the sooner counsel can determine the scope of IP due diligence, so that counsel may design and execute an efficient due diligence plan. If the transaction is a public offering, counsel should try to attend the first organizational meeting. If it is an M&A transaction, a private investment, or a major commercial transaction, counsel should try to get involved at the term sheet stage. Although it is not always practical for diligence counsel to be involved early, counsel should at least determine what will be needed when he or she obtains the go-ahead to begin due diligence. Counsel should understand at the outset the proposed structure of the transaction, the client's motivation for entering into it, and the client's alternatives, such as a different type of transaction or other interested parties. For example, a licensing transaction may often morph into an acquisition.

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§4.44 b. Team the Deal With Adequate Resources

If the transaction is a $20 billion M&A transaction that must be done in 3 weeks on a mature public technology target with hundreds or thousands of patents and scores of material intellectual property agreements, it will be important to assemble a large IP diligence team with appropriate patent- and technology-specific skills. Every transaction involves a balancing between having too many or too few team members. In the author's view, it is better to overstaff than to understaff. It is better to finish due diligence early with a large team, than to realize halfway through the process that there is inadequate staff to complete the necessary review before closing. The size of the team can always be reduced once the process is underway. Alternatively, in smaller transactions, it may be possible for one person to conduct the due diligence. If counsel is involved early, counsel can determine early on the size of the diligence team required. If the team uncovers a key risk, more resources may be required to further investigate and analyze that risk.

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§4.45 c. Always Ask, Who Does Counsel Represent?

Often this is a simple question to answer. Often it is not. If counsel is representing an underwriter, counsel may also technically be representing the interests of the participating underwriters. See §4.57. If counsel represents a venture capital investor, who is representing the other members of the investment syndicate? Consider an example in which counsel has represented a company as in-house or outside counsel in a second-round venture capital financing and is called on to conduct IP due diligence for the venture capital investors, some of whom participated in the first round and had engaged counsel before they became involved with the company. This example raises the question of conflicts of interest, and also the question of who is the client.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.46 d. Engage Patent Experts for Patent Review

§4.46 d. Engage Patent Experts for Patent Review

As discussed in §4.21, if patents are material to the transaction, counsel should ensure that the IP diligence team includes specialists to address patent matters. Experts may also be required for other forms of intellectual property if material to the valuation of the deal.

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§4.47 e. Invest in Process Planning

In intellectual property due diligence, no investment in proper process planning will be wasted. Once counsel has determined the scope of diligence needed and has assembled an adequate due diligence team, developing a careful road map for the investigation is paramount. The plan should include not only what gets reviewed first, to what extent, and what related materials must also be reviewed, but also who is responsible for what part of the review. If counsel has a large team, counsel, as leader, should assure that proper due diligence questionnaires are distributed, should act as a central repository for results, and should track and summarize each team member's contribution. Often, weekly or even daily contacts with the team will be in order. The process should also include contacts with the target and its counsel as necessary.

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§4.48 f. Hit High Risk Items First

Given time and cost constraints, it is rare that counsel will be able to review all of a target's key intellectual property, let alone all of its intellectual property. Counsel must prioritize the materials to be reviewed. By asking the questions discussed in this chapter and getting involved early, with careful process planning, counsel should be able to identify the items that present the most risk for the client. The items of highest economic risk should be reviewed first. Twenty percent of a target's IP may represent 90 percent of the economic risk in the transaction if it represents 90 percent of the target's revenues. Counsel may encounter surprises in the course of due diligence, and deadlines may change, and, if counsel runs out of time, the most significant items from the standpoint of risk, liability, disclosure, and assessment will have been covered.

Serially reviewing documents will not accomplish the goal of appropriate and efficient due diligence. For example, if counsel starts with the first agreement or first patent of a target company and proceeds from there, he or she might find out, when it is too late and too much money and time has been spent, that the target no longer uses the technology covered by those documents. To maximize the value of the entire diligence process, counsel should identify which products of the target company generate the greatest percentage of current or projected revenues or value and focus initially on the intellectual property that relates to those products. This can be done by reviewing the target's business plan, SEC filings or other offering documents, press releases, and other public information and consulting with the client, as well as the client's accountants and financial advisors. The documents to be reviewed should be arranged from the most important to the least important to counsel's assessment. A careful investment of time at the outset of any diligence exercise, to identify key documents and prioritize their review, will be the most valuable investment of time in any diligence project.

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§4.49 g. Communicate With Client Often

Client expectations change. Client motivations change. The nature of a transaction can change. What may start as due diligence for a collaboration agreement may end as due diligence for an acquisition. The client may first ask counsel to do minor diligence for an investment and then decide that it wants to conduct extensive diligence. The dynamics of business transactions change, and counsel's role and duties may change with them. The client may have told counsel that a certain product was most important in an M&A deal, and a month later state that another product is most important and that the first product has been discounted from the valuation. If counsel communicates regularly with the client throughout the diligence exercise, counsel will be able to adjust and modify the diligence efforts to keep pace with changing client expectations and dynamics. Constant communication with the client will help avoid surprises and help ensure that the diligence work product is what the client wants and needs.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.50 h. Follow Checklists and Use Forms to Streamline Process

§4.50 h. Follow Checklists and Use Forms to Streamline Process

Using checklists and forms in the due diligence investigation generally helps with efficiency and helps ensure that important items are not missed. Checklists and forms also help in the collection of documents and other information to be reviewed. As a part of careful process planning, counsel should create transaction-specific checklists and forms as guides in conducting the investigation. A sample due diligence checklist is presented in §4.73.

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IV. DUE DILIGENCE IN PARTICULAR TRANSACTIONS

§4.51 A. Private Investments

Private investment due diligence is foundational in that it often constitutes the first outside review of an entity's intellectual property position and serves as a basis, to some extent, of further due diligence investigations of the same entity for future private investments, public investments, M&A, or major commercial transactions. Private investment refers to investments by angel investor groups, venture capital firms, private equity firms, other financial institutions, or individual companies.

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§4.51A 1. Types of Private Investments

Private investments may be structured as private placements under §4(2) or Regulation D of the Securities Act of 1933, private investment in public equity (PIPE) offerings, or other forms of equity investment. Private investments can be made in very early stage companies as the first round of investment, as well as in mature public companies. The most common types of private investments are summarized in §§4.51B-4.51D. For further information regarding private equity investments, see Financing and Protecting California Businesses (Cal CEB 2006).

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.51B a. Regulation D Private Placements

§4.51B a. Regulation D Private Placements

Section 4(2) of the Securities Act of 1933 (15 USC §77d(2)) provides that transactions "not involving any public offering" are exempt from registration with the SEC. Regulation D (17 CFR §§230.501-230.508) was adopted by the SEC to clarify and expand the statutory exemptions from registration, including §4(2). If a company wishes to sell securities to private investors without registering its securities, it may do so if it meets the requirements under one of the three safe harbors from registration set forth in Regulation D, i.e., Rules 504, 505, and 506 (17 CFR §§230.504-230.506). Private placements made in accordance with Rule 506 are the most common because Rule 506 does not limit the amount of money that may be raised by the issuer or the number of accredited investors that may purchase the securities. Regulation D is the most common safe harbor for venture capital investments in early stage companies ("startups" or "venture-backed companies").

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§4.51C b. Private Investment in Public Equity (PIPE) Offerings

A private investment in public equity (PIPE) offering is a private placement completed in accordance with Rule 506 of Regulation D (17 CFR §230.506) in which a company sells securities to a limited group of private investors at a discount to the current market value of the securities without filing a registration statement beforehand. Because the investors in a PIPE offering receive illiquid securities, the sale of the securities is conditioned on the company's filing of a resale registration statement with the SEC on Form S-3—an abridged form of the standard registration statement on SEC Form S-1—within 60 to 90 days after the PIPE sale is consummated. Once the registration statement is declared effective, the investors may resell their securities to the public.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.51D c. Rule 144A Offerings

§4.51D c. Rule 144A Offerings

In accordance with Rule 144A under the Securities Act of 1933 (17 CFR §230.144A), restricted securities that are not listed on a U.S. securities exchange or quoted on an automated inter-dealer quotation system in the United States may be resold by persons or entities other than the original issuer to qualified institutional buyers, *i.e.,* institutions that are considered accredited investors. Securities that are resold in accordance with Rule 144A will remain restricted even after resale unless they can be resold in accordance with another exemption or until they meet certain requirements under Rule 144 and are no longer considered restricted securities.

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§4.52 2. Scope of Diligence Review

The timing of private investments in relation to a company's growth stages helps define the scope of diligence. Very early-stage companies in their first round of funding present significant risk because their business models are nascent and often unproven and their intellectual property protection embryonic. A company may not have filed any patent applications or may have completed only provisional applications, and no patents may yet have been issued.

NOTE: Provisional applications are often filed so that the company will have priority as the "first to file," but they are not reviewed by the U.S. Patent and Trademark Office until they are converted into nonprovisional applications within the year. See 35 USC §111(b). Companies often file such applications to minimize expenses until they can raise money, because the requirements for provisional applications are not as stringent as those for nonprovisionals.

An early-stage company's trademarks may be new, without distinctive meaning or substantial use in commerce. Later-stage private investments may rely, in part, on prior diligence or a presumption of prior diligence, and the dynamics will change. By then, patents may have issued, platform-validating deals may have been entered into, and trademarks may have acquired distinctive meaning or substantial usage in commerce.

For very early-stage companies, a key focus of due diligence is likely to be early patent applications, early trademark registrations (*e.g.,* bona fide intent-to-use applications under 15 USC §1051(b)), domain name registrations, and university in-license agreements, because these may be the only types of IP-related documents that the target has executed. Other key documents at this stage may include agreements among company founders and employment agreements with provisions concerning intellectual property ownership and assignment.

From an intellectual property standpoint, most early-stage venture capital or seed investors will focus heavily on the nature of the company's technology, its ownership, and its potential to support a profitable business model. This focus derives from the particular investment premise of the venture capital investors interested in the company. For example, for a biotechnology company, the investment model may be that the investors are willing to fund a first round of equity financing only if the company can demonstrate that it will be "in the clinic" with a drug product in 12 months. The IP due diligence will therefore need to confirm sufficient patent coverage of the drug molecule itself, the biological target (protein target), the therapeutic endpoint indication (the disease), and the formulation (*e.g.,* pill, nasal spray). To be "in the clinic," the company needs to have developed a drug in the form of a pill that modifies a target in order to treat a disease. Success in the clinic results in a market monopoly, which depends in large part on having a patent monopoly covering each of these elements.

For early-stage investment transactions, *e.g.,* in a biotechnology or pharmaceutical company, the patent monopoly is the most critical indicator of return on investment, assuming the company's drug ever makes it to market. Whether an early-stage company will in fact have a patent monopoly will be difficult to determine with no issued patents or even well-developed prosecution histories to review. Often, the company will have in-licensed its patent estate from a university, so in-license agreements become as critical to the diligence review as the patents themselves. In certain cases, where there is only in-house developed technology that does not have patent protection yet, the client may be well advised to have patent attorneys conduct a patentability analysis of the intellectual property to determine not only whether it can be properly protected, but also whether such protection may afford patent coverage of sufficient scope to thwart competition. Although no such analysis can provide a guarantee of protection and enforcement, it should help evaluate the risks involved in obtaining protection.

For later-stage pre-public companies, investors begin to look for validation of the business model in the form of issued patents and agreements with significant third parties, *e.g.,* for a biotechnology company, an early-stage collaboration agreement with a major pharmaceutical company, or for a software developer, a collaboration with a major software company. If patents are the core intellectual property asset, the scope of potential due diligence expands, both with respect to patent documents available for review and with respect to third party transactions that can validate the patent estate as well as modify the company's ability to exploit it, for better or for worse.

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§4.53 3. Standard Applied

In the case of private investments in private (*i.e.,* non-public) companies, the standard of review is very much driven by the client. Venture capitalists (VCs) and other early-stage investors are by nature more risk-tolerant, but still conduct careful due diligence examinations of the companies they invest in. General partners of venture capital firms have a fiduciary duty to their limited partners to invest within the investment guidelines of the fund and therefore investigate carefully before committing to an investment. Individual clients vary in the extent of their diligence and how much they balance diligence with representations and warranties of the target. Often a VC or other private investor will have a budget for diligence and push for representations and warranties to make up the difference. If the target is an early-stage company, however, there may not be many documents to review, so the cost of a diligence investigation may not be a problem. Large companies are typically more willing to bear the cost of an extensive examination. In general, the standard of review in private investment in private company transactions is heavily weighted towards client objectives and expectations, and less towards legal requirements. It is a key goal of diligence counsel to discuss with the client the potential scope of the examination and identify what the standard of review will be in the particular case.

Although a company need not need register its securities or the transaction with the SEC in a private placement, this exemption from registration does not mean that the company is not subject to SEC rules that shape the standard of review to be applied in conducting due diligence for the private placement. Private placements of securities in public companies are subject to Rule 10b-5 under the Securities Exchange Act of 1934 (17 CFR §240.10b-5), and the Rule 10b-5 standard is often of interest to private companies that are contemplating public offerings after private placements. Completing satisfactory due diligence before completing a private placement (to avoid making any material misstatements or omissions) can be as important as it is in the public offering context. Hence, the Rule 10b-5 standard is often applied in private company transactions. Rule 144A and PIPE offerings are subject to this standard, as well as Regulation D offerings in public companies. See §§4.56-4.60 for further discussion of the standard in the context of a public offering.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.54 4. Process

§4.54 4. Process

Generally, the client will detail what will be required for a due diligence examination in a private investment transaction, but the process typically includes:

- Reviewing the target company's business plan or other business summary;
- Obtaining and reviewing all relevant documents;
- Interviewing company founders and key scientists to determine, *e.g.*:
- Details about the target's technology area and its particular technology;
- Where the most innovative technology of the company is located;
- The history of the technology area, and the genesis of the technology within the company;
- Information about third parties in the same technology area;
- Any issues with other scientists, engineers, or others who may have contributed, or claim to have contributed, to developing the technology but who are not part of the current venture;
- Future plans to develop the technology further;
- The benefits of the technology to the market; and
- The target's business goals with the technology.
- Interviewing company patent counsel and other IP counsel (*e.g.,* trademark counsel) as relevant to determine, *e.g.*:
- Many of the same issues raised with company founders and scientists above;
- Any early intellectual property protection strategy;
- Knowledge of the technology area; and
- Any legal issues that they are aware of.

For PIPEs and Rule 144A transactions in public companies, a hybrid of the private placement and public offering due diligence process is appropriate. See §§4.56-4.65 for discussion of the public offering due diligence process.

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§4.55 5. What Should Counsel Deliver?

Some private investors require a memorandum summarizing the results of the diligence investigation. In such cases, the memorandum should consist of summaries only, and should not contain opinions, analysis, or conclusory statements. Any broad statements such as "to our knowledge, the claims of the patent applications cover the products planned as described by the company" should be carefully qualified. In the spirit of the "do no harm" oath (see §4.14), some practitioners believe it is better to provide the client with only a verbal summary of the results of the examination, so as not to create a paper trail that might not fully capture the scope and nature of the diligence. The risk is that a written memorandum may be subject to discovery in litigation and could be misconstrued or otherwise used in a manner harmful to the client. In general, if a memorandum is required, more time will be needed on the project to ensure that the memorandum is accurate and complete.

As a practical matter, these considerations are important. If the client has a very tight budget, but has requested extensive diligence, counsel may wish to suggest that the outcome of the diligence be delivered orally to avoid the cost of preparing a written work product. PIPE investments and Rule 144A offerings often result in oral disclosure rather than written work product, which is common in public offerings.

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§4.56 B. IP Due Diligence in Public Offerings

IP due diligence performed for a securities offering is perhaps the most standardized type of IP diligence examination. The offering may be an initial public offering (IPO), a secondary offering following an IPO, a takedown from a Rule 415 shelf offering (see 17 CFR §230.415), a registered direct offering, or an exempt transaction, such as an offering under Regulation D or Rule 144A of the Securities Act of 1933 (Securities Act) (15 USC §§77a-77aa), and may be for stock or notes. All securities offerings are subject to the Securities Act, the Securities Exchange Act of 1934 (Exchange Act) (15 USC §§78a-78nn), and the rules and regulations promulgated by the Securities and Exchange Commission (SEC) under those laws. See generally Financing and Protecting California Businesses (Cal CEB 2006).

The exact nature of the filing depends on the type of public offering. For example, for initial public offerings, an SEC Form S-1 registration statement is usually the document that is filed. For offerings after the initial public offering (so-called "follow-on" or secondary offerings, including Rule 415 shelf takedowns), a shorter SEC Form S-3 will often suffice. For foreign private issuers, SEC Form 20-F or Form 8-A can be used. The forms in turn refer to other SEC rules setting forth specific disclosure requirements, such as Regulation S-K (17 CFR §§229.101-229.1123) for textual disclosures and Regulation S-X (17 CFR §§210.1-01-210.12-29) for financial disclosures. See generally Financing and Protecting California Businesses. Although selection and preparation of the correct SEC forms are the purview of corporate attorneys, it is important for IP diligence counsel to have sufficient familiarity with the forms and applicable securities laws and regulations, because those laws and regulations dictate the legal standard applied to the transaction and often dictate the scope of due diligence review. See §§4.57, 4.60.

There are two key parties in public offering transactions: the issuer (*i.e.,* the target company whose securities are being offered for sale or sold) and the underwriters (*i.e.,* the investment banks that will underwrite the offering and help make a market for the securities when issued). Typically, the underwriters consist of a syndicate of national and regional investment banks, with one or more acting as lead underwriters, managing underwriters, or joint book-running managers, and other investment banks acting as participating underwriters.

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1. Types of Public Offerings

§4.56A a. Initial Public Offering (IPO)

When a private company desires to sell securities to the public for the first time, it will do so through an initial public offering (IPO), which typically requires approximately 3 to 4 months to complete. Because the IPO process is lengthy and complex, a company (referred to as the issuer) will not undertake an IPO on its own; it will engage lawyers to manage the process and underwriters to generate institutional and investor interest, to underwrite the offering, and to make a market for the issuer's securities. The issuer, the underwriters, and their lawyers draft and file a registration statement on SEC Form S-1, which will be the issuer's first public filing, and an offering document called a prospectus, which is filed as part of the registration statement. The S-1 contains important disclosures concerning the issuer's business, business and industry risks, and the issuer's financial condition (see §4.60). Of particular interest to IP diligence counsel are the risk factors pertaining to intellectual property, including the issuer's material IP agreements, and those parts of the management's discussion and analysis (MD&A) and other sections of the S-1 relating to the issuer's material intellectual property. The prospectus is distributed to potential investors during a "road show" in an effort to market the securities; it constitutes the key marketing document for the issuer's securities.

NOTE: For further discussion of IPOs and the steps involved in "going public," see Financing and Protecting California Businesses (Cal CEB 2006).

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§4.56B b. Follow-on Offerings

After an IPO, a company may issue and sell additional securities through follow-on offerings (also referred to as secondary offerings). To complete a follow-on offering, a company will generally prepare and file an SEC Form S-3. Under Rule 415 of the Securities Act of 1933 (17 CFR §230.415), once declared effective, a company's registration statement on Form S-3 (commonly referred to as a shelf registration statement) will remain effective for up to 3 years. This means that the company can take its Form S-3 down "off the shelf" and issue and sell the securities covered by that registration statement periodically during the 3-year period. By filing a shelf registration statement, a company can wait to complete a follow-on offering until market conditions are ideal.

Along with preparing and filing its shelf registration statement, an issuer will prepare and file a preliminary prospectus that incorporates information from the company's previous public SEC filings by reference. At the time the issuer decides to take its Form S-3 registration statement off the shelf and sell securities covered by the registration statement to the public, the company will prepare and file a preliminary prospectus supplement or a final prospectus (depending on the manner in which the offering is marketed), which describes the offering and is distributed to potential investors.

Companies may sell securities covered by Form S-3s taken off the shelf in various ways, including registered direct offerings or fully underwritten public offerings.

- **Registered Direct Offerings**. A very common type of follow-on offering is a registered direct offering. In a registered direct offering, the issuer sells securities to a select group of institutional investors (although the securities may also be sold to the general public) through a placement agency on a best efforts basis rather than through an underwriter. The placement agent never takes possession of the securities; it merely coordinates the sale of the securities to the investors.
- **Fully Underwritten Public Offerings**. A company may also choose to take its effective registration statement off the shelf and sell its securities in a fully underwritten offering, *i.e.,* a sale of the company's securities to the general public through underwriters.

As discussed further in §§4.60, 4.66, it is vitally important for issuer's counsel and the placement agent or the underwriters, as the case may be, to complete thorough due diligence before completing a follow-on offering. Although the anti-fraud rules of §11 of the Securities Act of 1933 (15 USC §77k) will not apply to a follow-on offering unless the issuer's shelf registration statement is incorporated by reference into the prospectus, it is nevertheless imperative to complete adequate due diligence to avoid liability under §12 of the Securities Act of 1933 (15 USC §77*l*), Rule 10b-5 under the Securities Exchange Act of 1934 (17 CFR §240.10b-5), and other applicable federal and state securities laws. Moreover, although a placement agent is technically not an underwriter, it is possible that a placement agent may be considered a *statutory* underwriter (see 15 USC §77b(a)(11)) and therefore subject to the anti-fraud provisions of the securities laws. Thus, both underwriters and placement agents should strive to complete sufficient diligence before a follow-on offering is consummated. This often proves difficult, given that many follow-on offerings are completed within a very short time frame (*e.g.,* weeks or even days instead of months).

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2. When Representing Underwriters

§4.57 a. Scope of Due Diligence Review

In most cases, by the time a technology company, for example, is ready to enter the public securities markets, it has built a significant intellectual property portfolio, in-licensed several technologies or products, or entered into a number of material intellectual property agreements. Life science companies, for example, may have entered into collaboration or partnering agreements with major pharmaceutical or medical device companies. Software companies may have entered into key VAR, OEM, or licensing and distribution agreements.

In the case of an initial public offering and other public offerings, the IP diligence team will be an important component of the larger team working on the transaction as a whole. The client that pays counsel's fees will often be the lead underwriter, but if there are co-managing underwriters and other syndicate members, all of the underwriting and participating investment banks named in the prospectus will be the "client" of underwriter's counsel. See Note in §4.60. As a result, counsel must answer not only to the lead underwriter, but also to the other banks involved in the transaction. In-house counsel at investment banks should be aware of this point.

Intellectual property due diligence for an IPO will be extensive, and will focus on the key type(s) of intellectual property that counsel has identified for the particular industry, such as trademarks or patents, and material IP agreements. For example, if the issuer is a patent-intensive enterprise, the IP diligence team for its public offering will include a patent expert to perform the patent diligence and an IP transactional attorney to perform due diligence review of the issuer's IP agreements. It is not uncommon for IP due diligence in the context of a public offering to require hundreds of hours of effort, and this should be considered by the deal team when staffing and planning IP due diligence.

The scope of due diligence for a public offering has two aspects:

- Review of the offering documents for adequacy and accuracy of disclosure; and
- Informing the client about the issuer's intellectual property and assessing the risks associated with that intellectual property.

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§4.58 b. Nature of IP Disclosure Diligence

In both public and private securities offerings, the primary goal of IP due diligence is to perform an independent investigation of intellectual property disclosures that the company has made and will make to the public in its offering materials. The focus is twofold—to confirm the accuracy of disclosures relating to the issuer's intellectual property, and to ensure that all material aspects of the issuer's intellectual property portfolio are adequately disclosed. In other words, the task is first to ensure that the statements made in the offering documents (and in the documents that they incorporate by reference) are accurate in the context of counsel's review of the issuer's patents, trademarks, and other intellectual property assets and agreements, and second, to ensure that there are no material omissions or misstatements in the offering documents. See §4.60 for discussion of the applicable legal standards.

To understand what is material in a particular transaction, it is important for counsel to understand the issuer's industry. For example, for life science companies generally, the most "material" types of agreement are collaboration agreements between life science companies and large pharmaceutical or medical device companies to develop the issuer's key products. Such agreements require detailed due diligence review, often including an interview with the other party to the agreement, as well as adequate disclosure in the offering documents. In addition, disclosures regarding the issuer's patent portfolio are normally material, and should not be drafted in a misleading way, such as failing to distinguish between United States and foreign patents or failing to address third party rights.

IP disclosure diligence will also focus on the underwriting agreement that governs the relationship between the underwriters and the issuer—in particular, whether the representations and warranties made by the issuer are adequate and whether any exceptions or exclusions are appropriate.

Finally, IP disclosure diligence usually involves requesting and negotiating IP comfort opinions from the issuer's outside or in-house patent counsel. This process may begin either before or after filing the offering documents with the SEC. Although obtaining appropriate "negative 10b-5 assurance" opinions mentioned in §4.39 from the issuer's patent counsel is an important aspect of allocating and mitigating risk in a financing transaction, it is not a replacement for the underwriters' obligation to conduct an independent investigation of the issuer's intellectual property.

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§4.59 c. Risk Assessment

In addition to due diligence concerning the disclosures made in the offering materials, the scope of diligence in a securities offering will also include the same elements common in private investment and M&A transactions, based on the need to inform the client of the level of risk in the transaction. A general understanding of the risks will result from the disclosure diligence, but the client will often ask for a general assessment of the issuer's intellectual property portfolio, an opinion regarding third party patents if there are issues related to them (*e.g.,* "freedom to operate" issues; see §§4.23-4.26), and an assessment of the issuer's collaboration agreements from an intellectual property perspective.

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§4.60 d. Standard Applied

One of the principal objectives of due diligence in securities offerings is to avoid liability under the antifraud provisions of Securities Act §§11-12 (15 USC §§77k-77*l*), Exchange Act Rule 10b-5 (17 CFR §240.10b-5), and other applicable federal and state securities laws. For example, §11 provides for strict liability and permits any person acquiring a security to sue every person who signed the registration statement, every director, every outside accountant who certifies any part of the registration statement, and every underwriter if any part of the registration statement "when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 USC §77k(a). Section 12 prohibits offers or sales of securities by means of an offering document that "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 USC §77*l*(a)(2). There are key differences in wording between §11 and §12, which result in a softer reasonable care standard in §12. In addition, §11 applies to the registration statement (*e.g.*, Form S-1), while §12 applies to the prospectus and any oral communications that constitute the offering of securities for sale.

In general, the standard for determining whether a particular fact or event is material is whether "there is a substantial likelihood that a reasonable shareholder would consider it important" or that the fact or event "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" (*TSC Indus., Inc. v Northway, Inc*., 426 US 438, 449, 96 S Ct 2126, 48 L Ed 2d 757 (1976); see also *DeMaria v Anderson* (2d Cir 2003) 318 F3d 170, 180)—in other words, whether a disclosure or its omission would likely impact the market price of the issuer's stock or would be considered important by investors when considering the total mix of information available to them.

The precise legal requirements for disclosure will vary depending on the type of securities offering involved. A detailed discussion of the federal and state securities laws is outside the scope of this book. It is essential for IP counsel to consult with securities counsel to understand the structure and scope of the disclosures required in the offering materials for the particular transaction, as well as the ongoing disclosure requirements after the issuer becomes a public company, together with any applicable stock exchange listing requirements. For example, as discussed in §§4.56-4.56A, in initial public offerings, the issuer is required to prepare and file with the SEC an offering document (known as a registration statement or "S-1"; see §§4.56-4.56A) with specific disclosures, including (among other things) descriptions of the issuer's business, the risks associated with that business and the industry generally, financial and accounting disclosures, information provided by management, and a description of the expected use of the proceeds of the offering. Disclosure of risk factors should include adequate disclosure of the risks associated with the issuer's intellectual property, especially its patents. A first draft of the risk factors section of the prospectus is usually prepared by issuer's counsel and is revised according to the outcome of the diligence review. For example, for life science companies, the discussion of risks associated with collaboration agreements will make clear that the issuer is dependent on a particular third party for its near-term revenue.

To a greater extent than in due diligence investigations for private investments, M&A, or third party agreements, underwriters in securities offerings will be guided by applicable legal standards in conducting due diligence examinations. Although underwriters also adhere to internal standards and practices, federal and state securities law constraints are of foremost importance. As discussed in §4.61, adequate due diligence is essential to comply with, and avoid liability under, those laws.

NOTE: Securities law liability extends to all participating underwriters even if the due diligence investigation is conducted by the lead underwriter. For this reason, participating underwriters often interact with diligence counsel, but their individual styles and objectives may vary, making the diligence review process more complex.

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§4.61 e. Due Diligence Defense

Although issuers are subject to strict liability for violations of §§11-12 of the Securities Act of 1933 (15 USC §§77k-77*l*), an underwriter may be absolved of liability for misstatements or omissions in the issuer's offering documents by proving that, *after reasonable investigation,* it had reasonable grounds to believe and did believe that the statements were true and that statements of material facts necessary to make the statements not misleading were not omitted. See Securities Act §11(b)(3) (15 USC §77k(b)(3)). In like manner, an underwriter can avoid liability under Securities Act §12(a) (15 USC §77*l*(a)) by proving that it did not know, and in the exercise of reasonable care could not have known, of any material untruth or omission in an offering document. See also Securities Act Rule 176 (17 CFR §230.176) (factors affecting the reasonableness of a §11 investigation). This statutory safe harbor is known as the "due diligence defense." See generally *In re Software Toolworks Inc. v Painewebber Inc*. (9th Cir 1994) 50 F3d 615. The defense does not apply to issuers of securities.

In determining whether an underwriter qualifies for the due diligence defense under either §11(b) or §12(a), courts apply the standard of reasonableness stated in §11(c), namely, "the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 USC §77k(c). Thus, due diligence is "in effect,… a negligence standard." *Ernst & Ernst v Hochfelder* (1976) 425 US 185, 208, 47 L Ed 2d 668, 96 S Ct 1375; *In re Software Toolworks Inc. v Painewebber Inc*. (9th Cir 1994) 50 F3d 615, 621. Under this standard, it is not enough for the underwriters to rely on the issuer's representations alone. Underwriters must make a reasonable attempt to independently verify the information provided to them, exercising a high degree of care. Underwriters "may not take at face value representations made to them by the issuer and its representatives, but rather must demonstrate they made a reasonable investigation of the facts to ensure there is no misstatement or omission of a material fact in the offering documents." *In re Worldcom, Inc. Sec. Litig.* (SD NY 2004) 346 F Supp 2d 628, 648. Consequently, underwriter's counsel should play the role of devil's advocate and perform an investigation that is reasonably calculated to uncover all the facts that would interest a reasonably prudent investor. If underwriter's counsel cannot independently verify information in the offering documents after making reasonable efforts to do so, counsel may rely on the issuer's representations.

For portions of an offering document made on the authority of an expert such as a certified public accountant (so-called "expertised" portions of the document), an underwriter need not conduct independent due diligence, but need only demonstrate that it had no reasonable grounds to believe and did not believe that the statements made in the expertised portion were untrue or misleading. 15 USC §77k(b)(3)(C). Expertised portions are generally limited to certified financial statements, and ordinarily would not include discussions of intellectual property.

NOTE: Resales of restricted securities to institutional buyers under Securities Act Rule 144A (17 CFR §230.144A) are not subject to §11 or §12 of the Securities Act. Therefore, a securities dealer participating in a Rule 144A transaction does not have the benefit of a statutory due diligence defense. Such resales are subject to Exchange Act Rule 10b-5 however. Practically speaking, counsel should expect to conduct due diligence in these transactions at the same level as would be appropriate in an original issuance of securities subject to §§11 and 12. Doing so will help ensure that the 10b-5 scienter requirement (see *In re Silicon Graphics Securities Litig.* (9th Cir 1999) 183 F3d 970) is negated and also to enable the client to comply with requests from accountants in delivery of their comfort letters.

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§4.62 f. What Is a "Reasonable" Investigation?

In conducting IP due diligence in the context of a public offering, it is a good practice for counsel to recognize that he or she is enabling underwriter clients to assert the due diligence defense. Counsel should ask the question, "Is this a reasonable independent investigation?"

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§4.62A (1) Time Available for Investigation Is Irrelevant

In re Worldcom, Inc. Sec. Litig. (SD NY 2004) 346 F Supp 2d 628 effectively raised the bar for a reasonable investigation by citing SEC Rule 176 (17 CFR §230.176) and quoting the SEC that Rule 176 standards were not intended to "modify the responsibility of the underwriters and others to make a reasonable investigation." 346 F Supp 2d at 669. Because there is very little case law on what constitutes a reasonable investigation for purposes of §11 of the Securities Act of 1933 (15 USC §77k), *Worldcom* has particular significance. The court indicated that the diligence standard does not diminish because a public offering is conducted in a matter of days or weeks rather than months. See 346 F Supp 2d at 669. Thus, the standard under §11 is the same for both (1) a registered direct offering done in a matter of days through a shelf takedown under Rule 415 on Form S-3 that incorporates Exchange Act reporting documents by reference and (2) an IPO done in a matter of months on Form S-1. Counsel for underwriters should best approach due diligence with the expectation that the standard of what is a reasonable investigation will be essentially identical for both types of offerings.

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§4.62B (2) Contact Issuer's IP Counsel and Review All Applicable Documents

Counsel should request a call with the issuer's intellectual property counsel to confirm statements made by representatives of the issuer concerning particular aspects of its intellectual property. If the issuer wonders why, counsel should educate the issuer regarding the underwriters' legal obligations to verify statements made to them. For example, if the issuer represents that it owns all of its patents, it will be appropriate to review the face of the patents and in-license agreements, but it will also be appropriate to verify the assignee noted on the face of an issued patent. It will be important to review whether assignments have been properly recorded and whether there have been any subsequent assignments not noted on the face of the patents. It is also important to review any in-license agreements to verify that they are not being breached such that the licensed rights could terminate. Similarly, reviewing employment agreements, consulting agreements, and proprietary invention and disclosure agreements help complete an independent investigation of ownership. Counsel should review patent titles in a manner similar to real property titles, making sure to trace ownership from the original patent owner through each subsequent transferee down to the company making the securities offering and independently verify the scope of coverage afforded by the issuer's patents.

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§4.62C (3) Are There Any Red Flags?

A reasonable investigation to confirm the accuracy of a simple statement such as "we own three U.S. patents that cover our product that expire in 2020" may require confirmation of ownership and review of not only the three patents in detail to confirm that they cover the "entire" product, and documents necessary to calculate their expiration (including terminal disclaimers, patent term extensions and adjustments, and other documents), but also review of additional documents such as the patents' prosecution history, interferences, oppositions, litigation pleadings, and collateral documents if any red flags are identified. Any time a red flag is identified, a reasonable investigation requires that that red flag be investigated in detail. When confronted with red flags, counsel must "look deeper and question more." *In re Enron Corp. Sec., Derivative & ERISA Litigation* (SD Tex 2002) 235 F Supp 2d 549, 707, dismissed in part on other grounds sub nom *Newby v Lay (In re Enron Corp. Sec.*) (SD Tex 2003) 258 F Supp 2d 576. Thus, what determines whether underwriters (and their due diligence counsel) conducted a reasonable investigation depends on "the presence or absence of 'warning signals.' " *University Hill Foundation v Goldman, Sachs & Co.* (SD NY 1976)_422 F Supp 879, 890.

For example, if IP due diligence counsel learns of the existence of a non-infringement opinion, unless counsel can review the opinion, counsel should query the issuer and the attorney who prepared the opinion regarding the facts and circumstances surrounding it. Counsel should also independently review the third-party patent or patents to which the opinion relates and conduct an independent evaluation of the issues surrounding the opinion. Red flags heighten the sensitivity of a reasonable investigation. If counsel finds a handful of material red flags, the entire investigation up to that point may be called into question. Counsel may then need to conduct its diligence with greater depth, scope, and scrutiny—which may substantially increase the time and cost of the task, but which may be necessary under the circumstances in order to be considered a reasonable investigation.

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§4.63 g. Reliance on Counsel Defense

Another defense to a securities fraud claim, which is similar to the due diligence defense, is the defense of good faith reliance on the advice of counsel. To be entitled to assert the reliance on counsel defense, a party must show that "they (1) made a complete disclosure to counsel; (2) requested counsel's advice as to the legality of the contemplated action; (3) received advice that it was legal; and (4) relied in good faith on that advice." *SEC v Goldfield Deep Mines Co.* (9th Cir 1985) 758 F2d 459, 467. A proper due diligence investigation will help assure the availability of this defense by assuring that the client learns, and has disclosed to counsel, all material facts on which the counsel's opinion will be based.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.64 h. Process

§4.64 h. Process

Usually, an underwriter client will detail what tasks it requires counsel to handle, but the process typically includes:

- Attending the "all hands" or organizational meeting for the transaction if possible to get an early view of the issuer's intellectual property. (Counsel may need to ask corporate counsel for an invitation, but this should save time later.)
- Ensuring that the IP diligence request list has been provided to the issuer.
- Reviewing the SEC Form S-1 registration statement or other offering documents for initial disclosure depth.
- If the offering is a secondary or Rule 144A offering, reviewing all of the issuer's annual and quarterly reports filed with the SEC since the last public offering, because these may be incorporated by reference into the new offering document or prospectus supplement.
- Interviewing the issuer's patent counsel and asking for an overview of the company's intellectual property, information regarding any current litigation or threats of litigation, a freedom-to-operate (FTO) analysis, and information about relevant third party patents.
- Prioritizing patents and patent applications for review according to (1) the products to which they relate, (2) the stage of development of these products (*e.g.,* "Phase III" drug testing, discovery stage technology, development stage software), and (3) the amount of revenue generated or expected to be generated by the products. In effect, counsel should start where the money is. This is where the investors will start and what the underwriters will focus their market-making activities on.
- Reviewing all relevant patents and patent applications.
- Reviewing all material trademark registrations and common law trademarks.
- Reviewing any material copyright registrations and copyright policies and procedures.
- Reviewing relevant trade secret policies and procedures if the issuer relies heavily on trade secret protection over patent protection.
- Reviewing all material IP agreements of the issuer, focusing on provisions that quantify risk.
- Interviewing the issuer's IP counsel and management as needed to guide the diligence and clarify key IP diligence issues. Underwriters often participate in these interviews.
- Briefing all underwriters on the status of diligence review.
- Revising the discussion of risk factors and other IP disclosures in the S-1 or other offering documents to reflect the outcome of IP diligence.
- Interviewing patent counsel again and any other IP counsel that may have prepared IP noninfringement or validity opinions on behalf of the issuer.
- Revising the S-1 or other offering documents again as needed.
- Conducting a "bring down call" with the underwriters to deliver the results of the due diligence investigation.
- Ensuring that the underwriting agreement or other agreement embodying the transaction contains the appropriate representations and warranties and exceptions or exclusions.
- Identifying which IP counsel of the issuer should prepare IP opinions.
- Negotiating the content of IP opinions with the issuer's counsel.
- Conducting "bring down" diligence as appropriate after the offering documents are filed with the SEC.

NOTE: The process described above calls for counsel to review existing public filings in the context of due diligence for a secondary offering. In an initial public offering, disclosure diligence focuses on the S-1 registration statement and company documents. But once the target is public, IP diligence counsel may be asked to conduct diligence for a secondary offering. Consequently, when performing disclosure diligence and conducting a detailed review of patent and other IP agreements, counsel should be aware that the issuer either is, or is about to become, a public company and will, on an ongoing basis, be subject to reporting requirements on SEC Forms 10-K, 10-Q, and 8-K, and under SEC Regulation FD and NASDAQ or other stock exchange rules. (For example, Item 1.01 of Form 8-K,

similar to Item 601(b)(10) of Regulation S-K, now requires disclosure of material definitive agreements that are not made in the ordinary course. Collaboration agreements for biotechnology companies will often fit that definition.) Documents filed with the SEC will become part of any secondary offering diligence review and also provide guidance on what the target's materiality standard is, which helps to enable more focused IP diligence.

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§4.65 i. What Should Counsel Deliver?

It is common practice for underwriter's counsel to provide only oral results and advice concerning the IP due diligence. Often, employees of the underwriters are duplicating elements of the IP due diligence investigation and therefore need to reconcile their efforts verbally with the efforts of underwriter's counsel. Moreover, as long as the underwriters receive a legal opinion, such as a negative 10b-5 assurance opinion, they can rely on that opinion. Underwriter's counsel, of course, may be liable on the same basis as the underwriters. The underwriters must be in a position to assert the due diligence defense successfully by relying on their counsel and demonstrating that they met the legal standards for due diligence. See §4.61. If necessary, underwriters may permit their counsel to reveal privileged information to support that defense.

PRACTICE TIP: It is important for IP counsel in securities offerings to set proper expectations both on the part of the client and with members of the corporate team. Often, counsel may be asked to provide comments on the first draft of an offering document. But counsel cannot opine on whether the disclosure is adequate and not misleading before conducting due diligence. Often, IP due diligence cannot be fully completed until right before the offering documents are filed with the SEC. Attempting to provide comments on offering documents prematurely, before due diligence is finished, is risky. If, however, counsel identifies (and confirms with appropriate follow-up) a material issue early on, it is important to bring it to the attention of the client and the corporate team as soon as possible, so that it can be addressed at that time. General risk factors should also be identified early on, but counsel should plan to enhance the substantive risk factor disclosure in the offering documents towards the end of the diligence process, after counsel has all information needed to fully evaluate the scope of risk disclosure in the documents.

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§4.66 3. When Representing Issuers

In general, issuer's IP counsel in securities offerings has fewer obligations than underwriters' counsel with respect to intellectual property due diligence. Regardless of the amount of due diligence that IP counsel conducts, the issuer has strict liability for material misstatements or omissions, and the due diligence defense is not available. Consequently, extensive IP diligence by the issuer's counsel during a public offering is not imperative from a liability perspective. However, to minimize its own liability under the offering documents and the underwriting agreement, the issuer does have an obligation to ensure that the representations and warranties in the underwriting agreement are accurate and not misleading. Therefore, the issuer must have its own counsel perform some level of IP diligence, at least to the extent necessary to validate its representations and warranties. Often, this will involve review of the same documents provided to underwriter's counsel with a view to identifying issues early and avoiding surprises later. It can also be required to support a negative 10b-5 assurance letter from issuer's counsel. See §4.39.

One key duty of issuer's counsel is to file so-called "FOIA Confidential Treatment Requests" (CTRs) with the SEC under SEC Rule 83 (17 CFR §200.83) to protect from disclosure under the Freedom of Information Act (5 USC §552) confidential portions of material agreements that are filed with the SEC as exhibits to the offering documents. Confidential Treatment Requests are technically complex and time-consuming to prepare. Ample time should therefore be allowed for preparation and filing CTRs. Among other things, each page of a document subject to a CTR must be marked and numerically coded. Discussion of the preparation of CTRs is beyond the scope of this chapter. See generally http://www.sec.gov/foia/conftreat.htm.

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C. IP Due Diligence in Mergers and Acquisitions

1. Types of Mergers and Acquisitions

§4.66A a. Mergers

Mergers of two or more companies into one can be structured in various ways, including consolidations, direct mergers, triangular mergers, and short-form mergers. A consolidation is a type of merger in which two companies merge into one entirely new company and both of the original companies cease to exist. In a direct forward merger, the target company merges with the purchaser and the purchaser is the surviving entity. Conversely, in a direct reverse merger the target company merges with the purchaser and the target company is the surviving entity. When a target company merges with a subsidiary of the purchaser and the subsidiary is the surviving entity (*i.e.,* the target company ceases to exist), the merger is referred to as a forward triangular merger. In a reverse triangular merger, a subsidiary of the purchaser merges with the target company and the target company survives as a subsidiary of the purchaser. In a short-form merger, a subsidiary merges with its parent corporation. The consideration paid or exchanged in a merger transaction may consist of cash or securities or both.

NOTE: For further general discussion of mergers, see Sales and Mergers of California Businesses (Cal CEB 2002).

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.66B b. Acquisitions

§4.66B b. Acquisitions

Acquisitions are transactions in which the acquiring company purchases either assets or outstanding stock of a target company.

NOTE: For further general discussion of acquisition transactions, see Sales and Mergers of California Businesses (Cal CEB 2002).

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§4.66C (1) Asset Purchases

In an asset purchase, the acquiring company may purchase all or substantially all of the target's assets and assume all of the target's liabilities. Alternatively, the parties may negotiate a purchase and sale of only part of the target's assets, and the transaction may or may not include an assumption of liabilities. Generally, the purchaser will create a subsidiary to hold the purchased assets and any related liabilities. An asset purchase transaction may consist of the acquisition of a particular business or product line of the seller, including all associated intellectual property.

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§4.66D (2) Stock Purchases

In a typical stock purchase transaction, the purchaser acquires ownership of the target company by acquiring a controlling interest in the outstanding securities of the target company. It is important to note that unless the transaction qualifies for one of the exemptions from registration under the securities laws (see generally Financing and Protecting California Businesses chap 6 (Cal CEB 2006); see also §§4.51-4.51C), the target's securities must be registered with the SEC before they can be sold. Stock purchase transactions in which the buyer, seller, and target company are each large private companies or other "accredited investors" usually qualify for exemption under §4(2) of the Securities Act of 1933 (15 USC §77d(2)) or Rule 506 of Regulation D (17 CFR §§230.506).

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§4.66E (3) Leveraged Buyouts

In a typical leveraged buyout, the purchaser acquires a controlling interest in a target company by funding most of the purchase price with the proceeds of a loan secured by the assets of the target company—in effect, by leveraging the target company's assets. The cash flows of the target company are used to pay the interest and principal of the acquisition loan. Generally, the debt-to-equity ratio in a leveraged buyout is 90 percent to 10 percent.

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§4.66F (4) Tender Offers

A tender offer is a transaction involving a public company target, in which a bidder makes a broad, public offer to the shareholders of the target to tender their shares to the bidder for sale at a premium over the current market price of the shares. The bidder makes the offer in an attempt to acquire a controlling percentage of one or more classes of the target company's outstanding securities, and the offer is generally contingent on the tender of a certain amount of securities.

The target company may react positively or negatively to such an offer. If the target reacts negatively, the tender offer will be considered hostile (*i.e.,* a hostile tender offer or hostile takeover). A company may also make a tender offer for its own shares (referred to as a self tender offer or stock buyback program), either to increase shareholder value or to defend against a hostile tender offer. It may also enlist the aid of a "white knight," *i.e.,* a third party that the target seeks to interest in acquiring the target in order to avoid being acquired by the hostile party.

Section 14(d) of the Securities Exchange Act of 1934 (15 USC §78n(d)), a part of the Williams Act (Pub L 90-439, 82 Stat 854), governs tender offers and requires the person or entity making a tender offer (including an issuer that wishes to make a self tender offer) to file a Schedule TO with the SEC before making the offer. See 17 CFR §240.14d-100. If the person or entity making the tender offer is not the issuer itself, the issuer will respond to the Schedule TO by filing a Schedule 14D-9. See 17 CFR §240.14d-101. The Schedule 14D-9 will include the board of directors' recommendation regarding the tender offer, if any (*i.e.,* a recommendation that the shareholders should either accept or refuse the offer). Because all documents, communications, and other materials used in a tender offer must be filed with the SEC, the Schedule TO is usually amended several times throughout the tender offer process to incorporate these materials.

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§4.67 2. Scope of Diligence Review

Factors Shaping the Review. A number of factors will play a role in shaping the nature and scope of IP due diligence for a particular merger or acquisition (M&A) transaction, including:

- whether the target company survives the merger or acquisition as an independent entity,
- whether the buyer and the target company are private or public companies,
- whether the buyer is a strategic or financial buyer,
- whether the transaction is being staged by the seller as a competitive bidding structure,
- whether the acquisition is hostile or not,
- whether it is a leveraged transaction or not,
- the amount of time allocated by the parties to complete the transaction, and
- the value of the transaction.

All these factors will color the scope of diligence and are therefore critical for diligence counsel to understand with respect to any M&A transaction.

Client Objectives and Expectations. Like due diligence investigations for private investment transactions (see §§4.51-4.55), due diligence performed in the context of M&A varies according to the client's objectives and expectations. M&A due diligence can be broad in scope and very expensive. The scope of M&A due diligence generally depends on the buyer's willingness to rely on the seller's representations and warranties in the purchase or merger agreement rather than performing extensive diligence. If the seller under an asset purchase agreement continues to conduct a profitable business after closing, the buyer may be more willing to rely on representations and warranties because the seller presumably would be available after closing as a source of recovery for damages for breach of contract or other claims. If, however, the seller is insolvent or ceases business operations altogether after closing, representations and warranties may not have any value unless, *e.g.,* the seller's potential liability exposure is reserved against in an escrow under the agreement. Similarly, if the seller is a public company with a large public float and will cease to exist after closing, the value of the seller's representations and warranties is limited because the sale proceeds will be distributed to many shareholders and there will be no "deep pocket" remaining to answer for damages for breach of representations or warranties. In such cases, the buyer should conduct a careful due diligence investigation of the assets purchased and the liabilities associated with those assets. The scope of diligence required may be reduced in an asset purchase context if the buyer does not assume all of the seller's liabilities related to the assets.

M&A Diligence Usually More Extensive. Regardless of what the contract says, in an M&A context, buyers want to know what they are buying and what liabilities come with the purchase and also need to support the valuation model they are using to price the deal. Consequently, in technology-focused industries such as life sciences and software, M&A IP due diligence will usually constitute an extensive task for buyer's counsel. Buyers in an M&A transaction typically require more extensive IP due diligence than in any other type of transaction, particularly if the buyer is a large, conservative, risk-averse company. Of course, the scope of due diligence on a $1 billion transaction will be different than on a $10 million one, but even small transactions may require extensive IP diligence depending on the liabilities involved.

Structure of the Transaction. The structure of the transaction will impact the nature and scope of the IP due diligence, particularly with respect to IP agreements to be reviewed. For example, in a reverse triangular merger, the target continues to exist as an independent entity. Accordingly, anti-assignment or change-of-control clauses in IP agreements may not be as important as they would be if the target merges into the buyer and does not survive the transaction. See §§3.44, 7.19 for further discussion of this issue. Change-of-control provisions become more important, however, in the context of asset purchase agreements.

IP Ownership. In all M&A transactions, due diligence review of ownership and the chain of title to patents, trademarks, and other intellectual property to be acquired is highly important.

Duration of Risk Assumed. Finally, depending on the identity of the buyer (strategic or financial) and the buyer's goals, the scope of a due diligence investigation may be designed to quantify risk for a certain period of time rather than indefinitely. A financial buyer that plans to exit its position in a few years may only be interested in that time frame, and will therefore focus on diligence items that constitute material risks to projected revenues during that time frame.

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3. Types of Buyers

§4.68 a. Strategic Buyers

Strategic buyers engage in M&A transactions to complement, supplement, and synergize their business with the seller's business. Strategic buyers are operating companies with one or more business units that may be seeking to acquire complementary products and technologies, to supplement their existing products and technologies, or to expand into new business areas. As a result, strategic buyers consider very important the impact that a target's intellectual property will have on their existing business. They also seek to identify key synergies, whether through cost saving or otherwise. Often their outlook is very long-term. These factors should always be taken into account when conducting IP due diligence for a strategic buyer. Because strategic buyers often inherit significant risks, liabilities, and obligations, they are often willing to invest considerable time, money, and resources to conduct extensive due diligence.

From a strategic buyer's perspective, the most important things are synergy, long-term value, hidden value, balance sheet impact, structural integration, assumed obligations and liabilities, and impact on consolidated revenue and net income (*i.e.,* earnings per share). Strategic buyers (like other buyers) always want to pay the lowest price possible, but they are often willing to pay a premium over the market value of the target company or its assets, because of the strategic nature of the transaction. For a strategic buyer, there may be discounting factors, such as cost synergies or impacts on competitors, that may justify a higher purchase price than one supported by a conventional valuation model. There may also be long-term opportunities that support the additional investment. For this reason, IP due diligence for strategic transactions often focuses heavily on long-term revenue potential as well as on the products and business relationships generating current revenue.

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§4.68A b. Financial Buyers

Financial buyers, such as private equity firms, engage in M&A transactions primarily as investments from which they expect to make a return within a reasonable amount of time. That return will come from revenues, dividends, or subsequent sale of the target, in whole or in parts (including both tangible and intangible assets), for a profit over the value represented by the purchase price. Often, a financial buyer will seek to obtain a return on capital through a public stock offering of the target. From a financial buyer's perspective, the most important things are purchase price, financiability of the transaction (particularly for leveraged buyouts), and cash flows of the target. Thus, from a due diligence perspective, in addition to the purchase price itself, the key items are things that may reduce value, such as key patent expirations or loss of exclusivity, over the period of time that the buyer expects to hold the investment. Discovery of any such items may help the financial buyer reduce the purchase price or else find an arbitrage opportunity by revealing hidden value in some form of IP. All things being equal and assuming full access to all relevant information, a financial buyer will not want to pay more than the present market value of the target company or its assets and of course would prefer to pay less. Diligence focused on those aspects of the target's intellectual property that most impact value today will therefore be critical.

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§4.68B 4. Standard Applied

In the context of M&A transactions, the standard for due diligence investigations is dictated by industry practice for similar transactions, the buyer's practices (including its internal policies), and the structure of the particular transaction (*e.g.,* whether liabilities are being assumed) and the type of buyer (strategic or financial). In general, the buyer should make some inquiry concerning any material issue arising in the transaction that appears objectively to require clarification. See *Hinesley v Oakshade Town Center* (2005) 135 CA4th 289, 303, 37 CR3d 364. Potential fiduciary obligations to the buyer's equity holders may also be implicated. For example, the ability of a corporate board member to successfully assert a defense under the business judgment rule relies (among other things) on the director having made a "reasonable inquiry" of the matter as would "an ordinarily prudent person in a like position… under similar circumstances." See Corp C §309.

The standard may also be affected by other parties to the transaction, such as investors and banks in leveraged transactions with their own requirements for IP due diligence as a condition of financing. Although investors and banks normally conduct their own independent IP due diligence, the buyer will often want to ensure that its own diligence is at least as extensive as that conducted by the entities financing the transaction and meets the same standards.

Most often, however, the buyer's standards for due diligence review, particularly the standards of a strategic buyer, are the strictest. Some buyers are very conservative and risk-averse. They examine every nook and cranny, verify every fact, evaluate every contingency, uncertainty, and risk (no matter how remote), and drill deeply into every aspect of the seller's business. They seek to quantify any risk with far greater granularity than other investors. In these cases, the buyer's standards may be much greater than the standards observed in public offerings, and the time and cost for due diligence may be significantly greater.

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§4.69 5. Process

The process for conducting due diligence investigations in M&A transactions is similar to diligence in private investment transactions (see §§4.51-4.55) or in underwritings of securities offerings (see §§4.56-4.65), depending on the status of the parties as private or public companies. More often, however, it is characterized by greater complexity, depth, and uncertainty.

It is not uncommon to conduct IP due diligence in M&A transactions in stages. For example, in competitive bidding situations, the seller may not be willing to disclose confidential information until prospective buyers have passed through one or two rounds of bidding or evaluation. In these cases, the first stage of IP due diligence may be limited to whatever public information buyer's counsel can obtain to evaluate the target's IP position. Once the buyer makes it past a few rounds, the seller may be willing to share some confidential information and additional diligence may be conducted. The seller may refuse to disclose particularly sensitive confidential information, such as trade secrets, until the final round, or even until after signing but as a condition to closing.

IP due diligence counsel must consider the structure of the transaction when planning and conducting IP due diligence in order to be able to provide the most value at each stage. Frequent communication with the client and the rest of the team is critical. Often during a transaction, IP diligence counsel may get the "pencils down" message as the transactional dynamics shift. Weeks or months may pass before the deal starts up again, at which time IP due diligence counsel may need to revisit diligence already conducted and update it, often on a very aggressive timeline. At this point, the focus or deal structure has often changed and the process must start anew, even though the deadlines have become shorter.

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§4.70 6. What Should Counsel Deliver?

As in the private investment context, the client will often request a written memorandum on the outcome of the due diligence investigation, and sometimes a series of memorandums, which can be very extensive. In addition, IP diligence counsel may be asked to provide summaries of the due diligence investigation to the company's board of directors for their review and approval in advance of the closing of the transaction. In performing his or her duties, a director is entitled to rely on information, opinions, and reports prepared by counsel regarding matters that the director believes are within counsel's professional expertise. Corp C §309(b). It is important to note that whatever is delivered to the client is likely to be used well into the future for strategic transactions, which should be taken into account when drafting counsel's work product.

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§4.71 D. IP Due Diligence for License, Collaboration, and Other Major IP Agreements

Often, counsel may be asked to perform due diligence for a licensee in connection with a major license agreement. This task is basically a hybrid between a diligence examination for a private investment (see §§4.51-4.55) and one for an M&A transaction (see §§4.67-4.70). Particularly in the case of an exclusive license, the transaction is similar to an asset acquisition. The license's importance and complexity will guide the scope of diligence review.

For collaboration agreements or other key IP-related agreements, the larger contracting party (such as a major pharmaceutical or software company) may wish to perform IP due diligence on the smaller party (such as a small biotechnology or software development startup). Due diligence in this setting also tends to be a hybrid between a diligence examination for a private investment (see §§4.51-4.55) and one for an M&A transaction (see §§4.67-4.70).

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V. SAMPLE FORM OF DUE DILIGENCE CHECKLIST

§4.72 A. Introduction

In §4.73 is an example of an intellectual property due diligence checklist that may be useful for technology-intensive targets, such as life sciences, medical device, or software companies. This checklist is for information only, and should not be regarded as exhaustive. Counsel should adapt the checklist to take into account the particular circumstances of the target company, the nature of its intellectual property, and the structure of the transaction contemplated.

PRACTICE NOTE: In situations where patent analysis is required, the analysis should be performed by attorneys having substantive experience with patents for the particular industry and technology involved, including relevant scientific background and either admission to the patent bar or experience prosecuting or litigating patents of that company. Because of the importance of patents in certain industries, clients often demand this level of expertise. Alternatively, if clients request a substantial freedom to operate (FTO) analysis (see §§4.23-4.26) and a more detailed analysis of claims, the lead due diligence counsel may wish to engage outside patent counsel through the client if lead counsel is not a patent attorney. Finally, when patent litigation issues become critical, patent litigators should be consulted.

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Source: Business Law/Intellectual Property in Business Transactions/4 Intellectual Property Due Diligence/§4.73 B. Form: Due Diligence Checklist

§4.73 B. Form: Due Diligence Checklist

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

Intellectual Property Due Diligence Checklist
For Patent-Intensive Target

I. DUE DILIGENCE PLAN

- A. Preliminary list of IP
- 1. Products, technology, names, logos, inventions
- 2. Patents, patent applications, copyright registrations, mask work registrations, registered and unregistered trademarks
- B. Source of IP (employee-developed, consultant-developed, licensed in from a university or government entity)
- C. List of documents to be reviewed
- 1. Licenses (in- and out-)
- 2. Development agreements
- 3. Strategic alliance and joint venture agreements
- 4. Distribution agreements
- 5. Employee agreements
- 6. Rights-acquisition agreements
- 7. Consultant agreements
- 8. IP litigation files and infringement correspondence
- 9. Written policies for IP protection
- 10. UCC and other security interest filings
- D. List of persons to be interviewed
- 1. Who is in charge of IP issues?
- 2. Inventors
- 3. Head of R&D
- 4. IP counsel
- 5. Founders

II. PATENTS (REQUIRES PATENT EXPERTS TO CONDUCT)

- A. Significance
- 1. Company patents (*i.e.*, "home grown" patents)
- 2. Third party patents (in-licensed or otherwise important to the company)
- B. Name of patent counsel
- C. Inventory
- 1. Copies of all patents owned by company.
If no copies available, list of all US and foreign patent numbers, expiration dates, etc.

- 2. All pending applications (and, if possible, copies of entire file histories)
- 3. Invention disclosures
- D. How does company maintain its patent portfolio?
- 1. Database?
- 2. Are patents being properly maintained? Have maintenance and annuity fees been paid?
- 3. Access to file histories for important patents
- 4. Are pending patents being prosecuted diligently?
- 5. Foreign filing dates
- E. Patent policies
- 1. How/who makes decision to file
- 2. Countries in which applications are filed
- 3. Decision to abandon
- F. Assignments of patent rights to company
- 1. Employees
- a. Employee agreements
- b. Policy re patentable inventions
- 2. Consultants; other third parties
- a. Assignment of IP rights
- b. Recording of assignments
- G. Coverage of patents (scope of portfolio)
- 1. How do company's patents relate to its business or products?
- a. What products fall within the scope of company's patents?
- b. Marking
- 2. Infringement of company's patents: Is anyone currently infringing? If so:
- a. Status
- b. Threats (estoppel)
- c. Litigation
- d. Negotiations
- 3. Any declared or anticipated interferences or oppositions
- 4. Importance of patents to competitive position
- H. Potential infringement by company of third party patents
- 1. Actual lawsuits
- 2. Threats
- a. Letters that use the "I" word
- b. Other (*e.g.,* license offers, that don't rise to the level of supporting a filing for declaratory relief)
- 3. Legal opinions. Validity, noninfringement. (Ask for copies or at least interview counsel who prepared the opinions.)
- 4. Potential significance to company's activities and assessment of risk
- a. Likelihood of threats becoming claims
- b. Prospective plaintiff

- (1) *Major competitor*
- (2) *Large company*
- c. How many patents
- d. Industry licenses
- e. Counterclaims
- I. Analysis of third party patents
- 1. Does the company monitor competitors' patents?
- 2. Are patents a significant factor in competitive market?
- 3. Are there industry cross-licenses or nonexclusive licenses?

III. COPYRIGHTS (IMPORTANT FOR SOFTWARE COMPANIES)

- A. Any software involved in database construction, control, or data collection or analysis, in addition to end-user software
- 1. Any work for hire involved?
- a. Agreement in place? When signed?
- b. Work under scope of agreement?
- 2. By employee under employment agreement?
- a. Agreement in place? When signed?
- b. Work under scope of agreement?
- 3. Any copyrights assigned?
- a. Is assignee author or owner?
- b. Work covered by assignment (termination rights?)
- c. Is assignment recorded?
- B. Any proprietary software needing protection?
- C. Any software in use needing licenses?

IV. TRADEMARKS (IMPORTANT FOR LATE-STAGE PRODUCT COMPANIES)

- A. Are there any?
- B. If so, expand due diligence checklist to include trademark search, etc. Consider involving trademark counsel if trademarks are particularly critical to valuation.
- C. At the very least:
- 1. Confirm federal registration on the primary register, including bona fide intent to use applications
- 2. Confirm ownership of each trademark by direct ownership or by license
- 3. Confirm that all fees for registration maintenance in all key jurisdictions and appropriate international classes are current and properly maintained

V. TRADE SECRETS

- A. Major areas with potential trade secrets
- 1. Unpatentable manufacturing processes?
- 2. Formulations?
- 3. Test methods?
- a. Animal models?
- b. Analytical methods for products?

- c. Manufacturing quality control specifications and protocols?
- B. Analysis of protection
- 1. Who has access
- 2. Physical security
- a. Keys
- b. Files
- c. Gates
- d. Database passwords
- 3. Employee agreements
- a. Entrance agreements
- b. Exit agreements and interviews
- c. Nondisclosure agreements (NDAs)
- d. Noncompete agreements
- 4. Have key employees left?
- a. To competitors?
- b. Access to trade secrets?
- c. Steps to protect such secrets?
- 5. Has company hired key employees from competitor? Screen other's trade secrets?
- 6. Vendor confidentiality agreements?
- 7. Any known threats? Disgruntled personnel?
- 8. Escrow agreements involving trade secrets?
- C. Any anticipated or actual trade secret litigation?

VI. OTHER RIGHTS ISSUES

- A. Biological materials
- 1. Any materials under bailments?
- 2. Any deposits, master cell banks, authentic samples?
- 3. How stored and protected?
- 4. Permissions for blood, tissue, or genetic materials?
- B. Other rights?

VII. LICENSE AND COLLABORATION AGREEMENTS

- A. License agreements
- 1. First, review in-license agreements with an eye to confirming the nature and adequacy of the license
- a. Is it exclusive or nonexclusive?
- b. What patents does it cover?
- c. What is the field?
- d. What is the territory?
- e. Does it include a license to improvements?
- f. What are the diligence requirements? Failure to meet them may result in reversion of the license to the licensor and consequently loss of rights under the underlying patents.
- 2. Next, review in-license agreements with an eye to ensuring that the scope and rights granted are

consistent with what the target company represents. (Often a company may state it has exclusive rights to a particular patent in all fields, but the license that provides those rights is limited to a much narrower field.)

- 3. Next, compare any disclosure in purchase agreements, investment documents, underwriting agreements, or offering documents for accuracy, and identify missing material items or misleading statements.
- B. Collaboration agreements
- 1. What products are covered?
- 2. What is the field?
- 3. Review all key provisions?
- 4. Compare disclosures to the agreements and identify missing material items or misleading statements

VIII. EMPLOYEE AGREEMENTS

- A. Ownership of IP invented or developed while employed
- B. Ownership of IP invented or developed postemployment for X period
- C. Cooperation with patent counsel postemployment
- D. Status of agreements (*e.g.,* royalty) re IP brought into company by current or former employees

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5

Intellectual Property Licensing

Jeffrey G. Sheldon

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§5.1 I. INTRODUCTION

This chapter presents the basics of licensing intellectual property and sample clauses for licensing agreements. Section 5.2 compares a license agreement and an assignment. Section 5.3 identifies the types of intellectual property that can be licensed. Sections 5.4-5.82 discuss the terms that are found in most license agreements for intellectual property. There are also terms used for license agreements that are specific to the type of property being licensed. For example, quality control provisions are present in most trademark license agreements (see §§5.97-5.98) but not in trade secret license agreements. Sections 5.83-5.110 deal with these types of specialized terms. A complete form of patent license agreement is presented in App A.

NOTE: For an overview of the major considerations in structuring an intellectual property licensing transaction, see §§3.29-3.33, 3.48.

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§5.2 A. License Versus Assignment

The difference between a license and an assignment is similar to the difference between leasing property and purchasing it. A lessee has rights in the property, but does not own it. Similarly, a licensee has certain rights in the intellectual property as defined in a license agreement, but does not have ownership rights. There are, however, many similarities between a license and an assignment. If the license is exclusive, and as the licensee obtains more and more rights in the licensed intellectual property, the license becomes akin to an assignment. Moreover, an assignment may have provisions comparable to a license agreement, such as a provision having royalties paid over time as all or part of the consideration for the assignment.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.3 B. Types of Intellectual Property for Licensing

§5.3 B. Types of Intellectual Property for Licensing

There are four basic types of intellectual property that are commonly licensed:

- Inventions, including patents and patent applications for the inventions;
- Trade secrets;
- Trademarks; and
- Copyrights.

A license agreement may cover more than one type of intellectual property. For example, a software license for patented software would necessarily include a license under the patent and any copyright in the software, and may also include a license in related trade secrets and trademarks.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.4 II. COMMON PROVISIONS OF LICENSE AGREEMENTS

§5.4 II. COMMON PROVISIONS OF LICENSE AGREEMENTS

Sections 5.5-5.82 review provisions found in most license agreements, independent of the intellectual property being licensed, and in most cases include one or more sample clauses.

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A. Introductory Provisions

§5.5 1. Introductory Clause

The introductory clause of the license agreement (see, *e.g.,* §5.6) sets forth the parties and their addresses. Commonly, the parties are identified as "Licensor" and "Licensee." It is recommended, however, that a short version of each party's name be used instead, so that the agreement appears customized and to avoid drafting mistakes due to the similarity in the terms "Licensor" and "Licensee." For example ABC, Inc. may be defined as "ABC" and Profiting National, Inc. may be referred to as "Profiting." The introductory clause typically specifies a pertinent date, which often is defined as the "Effective Date" of the agreement.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.6 2. Form: Sample Introductory Clause

§5.6 2. Form: Sample Introductory Clause

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5.6-1 Sample Introductory Clause

This License Agreement ("Agreement"), dated _ _[*date*]_ _**, and effective as of the Effective Date (defined below), is entered into at** _ _[*city and state or country*]_ _ **by and between** _ _[*full company or entity name*]_ _**, a** _ _[*name of state or country if applicable*]_ _ _ _[*individual/corporation/partnership/limited liability company/other form of legal entity*]_ _**, having an office at** _ _[*street address, city and state or country, zip code*]_ _ **("Licensor"), and** _ _[*full company or entity name*]_ _**, a** _ _[*name of state or country if applicable*]_ _ _ _[*individual/corporation/partnership/limited liability company/other form of legal entity*]_ _**, having an office at** _ _[*street address, city and state or country, zip or postal code*]_ _ **("Licensee"). Licensor and Licensee are also referred to in this Agreement individually as "Party" and collectively as "Parties."**

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§5.7 3. Recitals

A license agreement need not include recitals, but they are almost always present. The principal purpose of recitals is to state the business context of the license agreement. For examples, see §5.8. Recitals may be of great assistance to a court in interpreting the terms of the agreement if a dispute arises. Recitals may include such information as:

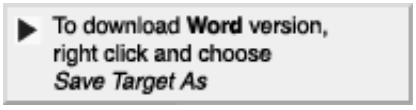
- The business rationale for the agreement;
- Preexisting relationships between the parties;
- Reference to prior agreements;
- Introduction of the licensed subject matter; and
- Options rejected, such as an assignment or an exclusive license.

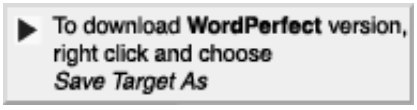
It is recommended that each recital be labeled with a letter (A, B, C) to easily identify each recital, and to distinguish the recitals from the agreement terms, which are typically numbered.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.8 4. Form: Sample Recitals

§5.8 4. Form: Sample Recitals





5.8-1 Sample recitals in agreement settling litigation

A. This Agreement _ _[*supersedes/serves as a novation of/ incorporates by reference*]**_ _ the prior _ _**[*title of agreement*]**_ _ agreement between the Parties dated _ _**[*date*]**_ _.**

B. This Agreement settles pending U.S. District Court, _ _[*designation*]**_ _, District of California, Civil Action Number _ _**[*number*]**_ _ between the parties concerning _ _**[*description of litigation*]**_ _.**

C. Licensee desires to obtain a(n) _ _[*exclusive/nonexclusive*]**_ _ license to use certain technology in the Field under certain _ _**[*patent(s)/patent application(s)/trademark(s)/copyright(s)/know-how/trade secret(s)*]**_ _ that are owned or developed by Licensor; and Licensor is willing to grant to Licensee a license to use such _ _**[*patent(s)/patent application(s)/trademark(s)/copyright(s)/know-how/trade secret(s)*]**_ _ as pertain to technology in the Field on the conditions set forth in this Agreement.**

NOW THEREFORE, the parties agree as follows:

5.8-2 Sample recitals in trademark license

A. WHEREAS Licensor is the owner of all right, title, and interest in and to the Mark and the copyright in the Work described in Section 1(a) below;

B. WHEREAS Licensee desires to use the Mark and reproduce and distribute the Work throughout the world (the "Territory") on, and in connection with the manufacture by or for Licensee, promotion, and sale of the articles listed on the attached Exhibit A (the "Articles"); and,

C. WHEREAS Licensor is willing to grant to Licensee the exclusive right and license to use the Mark and license certain rights in the copyright in the Work in the Territory on and in connection with the manufacture by or for the Licensee, promotion, and sale of the Articles on the terms and conditions of this Agreement.

NOW, THEREFORE, in consideration of the covenants, conditions, and undertakings set forth herein, and for other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties agree as follows:

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.9 B. Definitions

§5.9 B. Definitions

It is advantageous to define key terms in a separate definition section. Doing so may allow for a shorter agreement if many key terms are repeated. Including definitions also allows the parties to focus on key terms during their negotiations. Defined terms should have initial capitalization or be in all capitals. Sections 5.10-5.21 illustrate terms that are commonly defined in license agreements.

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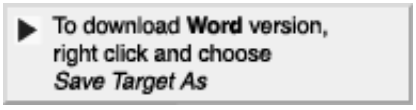
§5.10 1. Licensed Intellectual Property

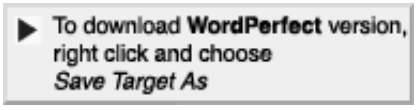
The licensed intellectual property may be patents and patent applications, U.S. and foreign; trademarks, including trademark registrations; copyrightable subject matter, including copyright registrations; trade secrets; or a combination of more than one type of intellectual property. See, *e.g.,* the sample definitions in §5.11.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.11 2. Form: Sample Intellectual Property Definitions

§5.11 2. Form: Sample Intellectual Property Definitions





5.11-1 Sample definition of trade secrets

"Trade Secrets" means, as of the Effective Date, all business and technical information relating to _ _[*description of product, process, or both*]_ _ that exists as of the Effective Date and that Licensor is free to disclose. Such information, more fully described in Exhibit A of this Agreement, includes, but is not necessarily limited to, _ _[*description of information*]_ _.

5.11-2 Sample definition of patents

"Patents" means all patents issued as of the Effective Date and all patents issuing in the future on patent applications pending as of the Effective Date of this Agreement, as well as patents issuing from later filed continuations, substitutions, continuation-in-parts, or divisionals thereof, and any reissues thereof, that Licensor either owns or, as a licensee, has the right to sublicense and that cover _ _[*description of process, product, or both*]_ _. Such patent rights are limited to patents in the Territory. The listing of patents and patent applications provided in Exhibit A of this Agreement illustrates, but may not include all of, Licensor's patent rights in the Territory.

5.11-3 Sample definition of trademarks

"Trademarks" means Licensor's registered and unregistered trade names, trademarks, and service marks that relate to Licensor's Products or Services.

5.11-4 Sample definition of copyrights

"Copyrights" shall mean Licensor's copyrights in the works identified in Exhibit A.

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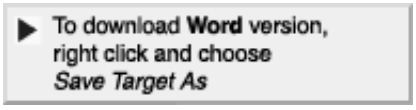
§5.12 3. Territory

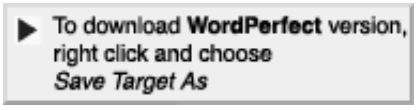
The rights granted under the license agreement may be for any geographical territory ranging from the entire universe to a specific country or to a particular portion of a state. See, *e.g.,* §5.13. For trademark licenses, the territory may be a very specific location. For example, a restaurant franchise agreement may specify the territory as a specific street address.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.13 4. Form: Sample Definition of Territory

§5.13 4. Form: Sample Definition of Territory





5.13-1 Sample definition of territory

"Territory" means all states west of the Mississippi River, the state of Maine, and the European Union as it exists on _ _[*date*]_ _.

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§5.14 5. Field of Use

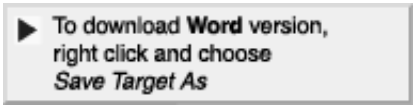
Some licenses may be limited to a particular field of use. See §3.33. For example, a coating composition may be licensed to one manufacturer for commercial sales and to another manufacturer for retail sales. The same coating composition can be licensed to a first licensee for sale to manufacturers of airplanes and to a second licensee for sale to manufacturers of automobiles.

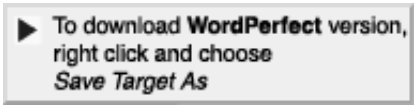
A trademark can be limited to certain channels of commerce, such as wholesale sales, high end retail sales, or Internet sales.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.15 6. Form: Sample Definition of Field of Use

§5.15 6. Form: Sample Definition of Field of Use





5.15-1 Sample definition of field of use

"Field" means _ _[*e.g., agricultural products/all channels of commerce except Internet sales*]_ _**.**

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§5.16 7. Affiliates; Subsidiaries

Frequently, a license grant may encompass affiliates or subsidiaries of the licensee. If so, it is advisable to include a definition of "affiliates." See, *e.g.,* §5.17. The definition section may also define the term "Licensee" as including subsidiaries and other affiliates of the licensee.

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§5.17 8. Form: Sample Definition of Affiliate

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5.17-1 Sample definition of affiliate

"Affiliate(s)" of any specified Person means any other Person that, directly or indirectly, is in control of, is controlled by, or is under common control with such specified Person. For purposes of this definition, "control of a Person" means the power, direct or indirect, to direct or cause the direction of the management and policies of such Person, whether by contract or otherwise; and the terms "controlling" and "controlled" have meanings correlative to the foregoing.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.18 9. Sales; Net Selling Price

§5.18 9. Sales; Net Selling Price

If the license includes a royalty payment, often the royalty is based on sales of particular products or net sales of the product. The difference between sales and net sales is that certain revenue received by the licensee is excluded from net sales. For example, freight, returns, sales taxes, and free samples can be deducted from a selling price to yield net selling price. See, *e.g.,* §5.19.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.19 10. Form: Sample Definition of Net Selling Price

§5.19 10. Form: Sample Definition of Net Selling Price

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5.19-1 Sample definition of net selling price

"Net Selling Price" means, for purposes of computing royalties under this Agreement, Licensee's invoice price for Product(s), f.o.b. factory, on an arm's-length trade basis, after deduction of quantity discounts, but before deduction of any other items, including, but not limited to, freight allowances, cash discounts, and agents' commissions.

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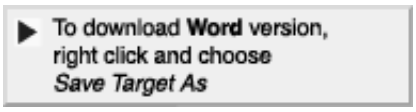
§5.20 11. Licensed Product

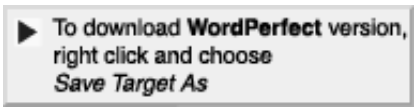
The definition of licensed product is often a vigorously negotiated term. The term generally defines exactly what the licensee can sell under the licensed rights. The term may also be used as the base for calculation of royalties. For examples, see §5.21.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.21 12. Form: Sample Definitions of Licensed Products

§5.21 12. Form: Sample Definitions of Licensed Products





5.21-1 Sample definition of licensed product, referring to specific patents

"Licensed Product" means all products within the scope of any claim of the Licensed Patents.

5.21-2 Sample definition of licensed product, referring to attachment

"Licensed Product" means the toys shown in Attachment A.

5.21-3 Sample definition of licensed product, for a derivative work

"Licensed Product" means a musical produced as a derivative work from any of the books identified in Attachment A.

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C. Grant of Rights

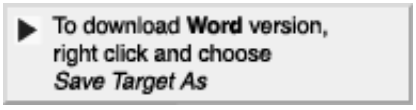
§5.22 1. Grant of Rights

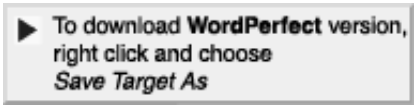
The grant of rights is one of the key terms of any license agreement. See §3.33. For sample granting clauses, see §5.23. It is very important for the licensor and licensee to clearly understand exactly what rights are granted, and for the licensee to make certain that sufficient rights are granted for its business purposes. One common issue is whether the rights granted are exclusive or nonexclusive. Clarity is also needed to determine whether the term "exclusive" is meant to exclude the licensor as well as third parties from exercising any of the rights granted. There also needs to be a definition of what the licensee can do with the rights granted. Examples of what can be granted are the following rights:

- To make;
- To have made;
- To sell;
- To use;
- To import;
- To export;
- To offer to sell;
- To distribute;
- To publish;
- To copy;
- To perform; and
- To create derivative works.

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§5.23 2. Form: Sample Granting Clauses





5.23-1 Sample grant of rights, including patents, trademarks, and know-how

Licensor grants Licensee a(n) _ _[*nonexclusive/exclusive*]_ _ license for a _ _[*number*]_ _-year period of time after which it becomes _ _[*exclusive/nonexclusive*]_ _ save for (1) Licensor, and (2) rights granted under a prior license to_ _[*name*]_ _. The license is _ _[*royalty-bearing/royalty-free*]_ _, _ _[*assignable/nonassignable/nonassignable without Licensor's prior written permission*]_ _. The license includes the right to sublicense under terms approved by Licensor, subject to sharing of consideration with Licensor. The license includes the right to extend to Affiliates. The license is for Licensor IP Rights, including Patents, Trademarks, and Know-How, and includes the right to make, have made, use, lease, sell, export, import, offer to sell, and resell Product(s), use Process _ _[*or both*]_ _ in the Territory in the Field.

5.23-2 Sample grant of trademark rights, geographically limited

Licensor grants to Licensee an exclusive license, limited to the State of _ _[*name of state*]_ _, to use the Licensed Marks for the respective goods and services set forth in Attachment A.

5.23-3 Sample grant of rights, musical composition

Licensor grants to Licensee the nonexclusive right to use, reproduce, and sell the Original Composition identified in Attachment A. Licensee may re-mix, edit, or create new derivative versions of the original Composition. This grant of rights shall be for the full term of copyright of the Original Composition. Licensor also grants to Licensee and its assigns the right to include and exploit the Original Composition for Internet usage, video clips, and audiovisual uses, all solely for advertising and promoting the sale of the Original Composition. This grant shall be binding on Licensee's assigns and sublicensees. Licensor retains all rights other than those granted in this Agreement.

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§5.24 3. Limitations on Grant

Often there are limitations on the rights granted. The limitations may include such terms as:

- **Quantity.** The licensee may be limited in the amount of licensed product it is allowed to manufacture.
- **Price.** The licensor may wish to specify a minimum price or a fixed price for the licensed product, particularly when the licensor is also in the marketplace. (It is prudent to consider whether such restrictions raise antitrust concerns.) See *Leegin Creative Leather Products, Inc. v PSKS, Inc.* (2007) 511 US 877, 168 L Ed 2d 623, 127 S Ct 2705.
- **Term.** The temporal length of the grant clause must be specified. For a patent, the license term is often until the patent expires, but it need not be. Sometimes the term is limited to a certain number of years, with options to extend for additional terms.
- **Channels of commerce**. In many license grants, the channels of commerce that the licensee can use are specified. The channels of commerce may be divided up in any way that makes business sense, such as retail sales versus industrial sales, or direct-to-consumer sales versus retail outlet sales.
- **Reservation of rights clause.** The license agreement should specifically state that any right not granted is reserved for the Licensor.
- **Limitations on Licensee's Customers.** Under the first sale doctrine, also known as the exhaustion doctrine, the first unrestricted sale of a patented item exhausts the patentee's control over that particular item. See *Quanta Computer, Inc. v LG Electronics, Inc.* (2008) ___ US ___, 170 L Ed 2d 996, 128 S Ct 2109, 2115. A similar doctrine exists in copyright law. See 17 USC §109. Thus, if a licensee legitimately sells a licensed item, a restriction on what the customer can do with the licensed item may be unenforceable.

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§5.25 D. Royalty

The royalty provisions are usually vigorously negotiated terms. The royalty payable may take many different forms, as discussed in §§5.26-5.42. See also §3.32.

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§5.26 1. Lump-Sum Versus Ongoing Royalty

The royalty can be a lump-sum payment or a payment on an ongoing periodic basis. Typically, the royalty involves ongoing payments over the term of the license agreement, but in some instances it may be a fixed sum, payable all at once or payable over time. The ongoing royalty can be based on variables such as the licensee's sales, profits, savings, or the like. Alternatively, the ongoing royalty can be structured as fixed periodic payments.

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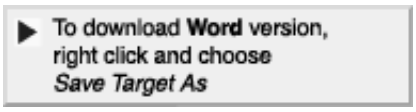
§5.27 2. Up-Front Payments

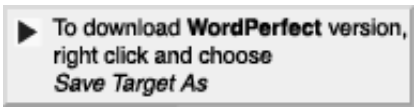
Even when there is an ongoing royalty, it is common to have an initial up-front payment. See, *e.g.,* §5.28. An up-front payment is usually requested by the licensor to show the good faith of the licensee, to be certain that there is some return from the license, and to cover the transactional costs, such as attorney fees associated with negotiating and preparing the license agreement. The up-front payment may be in addition to an ongoing license fee or an advance against ongoing royalty payments. Usually, up-front payments are nonrefundable, *i.e.,* if the licensee decides not to use the rights granted, the licensee is not entitled to a refund of the payment made.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.28 3. Form: Sample Up-Front Payment Clause

§5.28 3. Form: Sample Up-Front Payment Clause





5.28-1 Sample provision for up-front payment

Licensee agrees to pay to Licensor, promptly on the execution of this Agreement, the sum of U.S. $_ _[*amount*]_ _ as an initial fee and _ _[*not as/as*]_ _ an advance payment of minimum or earned royalty.

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§5.29 4. Minimum Performance Requirements

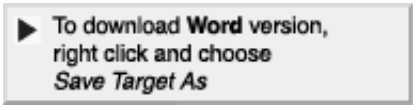
It is common to have minimum performance requirements for the licensee, particularly when the license is exclusive. The minimum may be expressed as minimum royalties (see, *e.g.,* §5.30) or minimum sales of the royalty base, or other minimums. From the licensor's perspective, the minimum should be at least the amount that—if the licensor received nothing more, particularly for an exclusive license—would satisfy the licensor for having made the agreement.

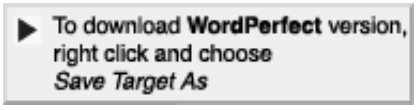
In an exclusive license arrangement, the consequences of nonperformance need to be negotiated. One option is termination of the license. Another option is to convert the license to a nonexclusive license. Sometimes a two-tier approach is used, *e.g.,* if a first minimum is not satisfied, the license becomes nonexclusive, and if a second lower minimum is not satisfied, the license is terminated. Typically, the licensee is given the option of making up any deficiency between the minimum and an actual earned royalty to keep the license in place. It is less common to include a minimum in nonexclusive licenses. If there is a minimum requirement in a nonexclusive license, generally the consequence of failing to meet the minimum by the licensee is termination of the license.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.30 5. Form: Sample Minimum Royalty Clauses

§5.30 5. Form: Sample Minimum Royalty Clauses





5.30-1 Sample minimum royalty clause, fixed annual payments

Licensee shall pay Licensor a minimum annual royalty of U.S. $_ _[*amount*]_ _ beginning with the calendar year 2007. Any difference between earned royalties for a calendar year hereunder and the specified minimum is to be paid with the accounting report for each calendar fourth quarter.

5.30-2 Sample minimum royalty clause, specified annual payments

The minimum annual royalty payable by Licensee to Licensor pursuant to the terms of this Agreement shall be U.S. $_ _[*amount*]_ _ for the first year of this Agreement, U.S. $_ _[*amount*]_ _ for the second year of this Agreement, and U.S. $_ _[*amount*]_ _ for each succeeding year of this Agreement.

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§5.31 6. Royalty Base

What is used as a base for calculating royalties is whatever makes business sense and what can easily be calculated. Examples of royalty bases are:

- Cost savings achieved from the licensed product.
- Sales or net sales of the product licensed.
- Profits resulting from the license.
- Sales or profit increases resulting from the license.

It is best to use an easily ascertainable number. Thus, use of profits as a royalty base is generally disfavored, in that exactly how profits are determined, including allocation of costs, can lead to disputes between the licensee and the licensor. Likewise, cost savings can be difficult to determine; if the amount of cost savings is used as the royalty base, a method to determine the cost savings should be included in the agreement. A preferred base for calculating royalties is a preapproved list price to be redetermined annually, with narrowly defined exclusions. Using a preapproved list price avoids the problem of the licensee bundling licensed goods with non-licensed goods, and discounting the licensed goods while obtaining full price for the non-licensed goods.

Sometimes there are exclusions from the royalty base. For example, it can be recognized that a percentage of product produced under a license is given away as samples, and thus a fixed percentage of product produced is excluded from the royalty calculation. If a licensee has been using the licensed intellectual property before the license agreement is implemented, consideration needs to be given to whether or not a royalty should be paid for the prior use.

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7. Royalty Rates

§5.32 a. Guidelines for Determining Royalty Rates

An often contentious issue during license negotiations is determination of a royalty rate. It is important for all involved to recognize that the profits of a business result from many factors, including:

- Management;
- Manufacturing;
- Marketing;
- Money (capital); and
- Intellectual property

Thus, licensed intellectual property is only one of many factors that can lead to a profit.

An initial factor in establishing a fair royalty is to determine what profit margins can be expected from use of the intellectual property. A licensee usually cannot afford to pay a royalty greater than what is generated in profits or realized in cost savings. A second factor is to determine the relative contributions of the various components of the business to its success, *i.e.,* how important is the intellectual property? For some products, such as new therapeutic drugs, intellectual property is a very important component. For other products, such as mass-produced consumer items, the intellectual property may be only a very small component of the success of the product.

If a profit margin of 25 percent is assumed and all five factors above contribute equally to the success of the business, the result is a royalty rate of about 5 percent—a number often used as a starting point for negotiations. However, when dealing with proprietary drugs and computer software—both of which may have very high profit margins and which have intellectual property as a major component of their success—royalty rates may exceed 5 percent. When dealing with mass-produced consumer products—which may have lower profit margins and for which marketing is usually an important factor of success—royalty rates of less than 5 percent are not unusual.

The royalty rate need not be a percentage of a royalty base. It can be a fixed number, such as $5 per unit sold. The royalty rate need not be fixed, however; instead, it can vary with increases or decreases in the royalty base. It is common for a licensee to argue that, as sales of licensed product increase, the royalty rate should decrease because the licensor is receiving more royalty payments. But it is also common for the licensor to argue that as sales increase, the royalty rate should increase, because the licensee's profits increase greatly because its fixed costs remain relatively steady. Further, licensees often request that royalties be capped, either on a yearly basis or over the entire term of the license agreement.

When the royalty rate is a fixed amount per unit sale, an inflation factor is sometimes included so that the fixed amount increases with inflation. The inflation factor may be based on the consumer price index or other indices provided by the federal government.

Other factors may be used to vary the royalty rate during the term of a license agreement. For example, for a licensed invention for which no patent has issued, there may be a provision for an increase in royalty rates if the patent does issue. Alternatively, there may be a provision for a decrease in royalty rates on the unpatented invention if a patent does not issue within a certain amount of time. Royalty rates can also vary with the territory licensed and the channels of commerce. Some countries may support higher profit margins and thus higher royalty rates than others. Likewise, some channels of commerce may be more profitable than others and thus justify higher royalty payments.

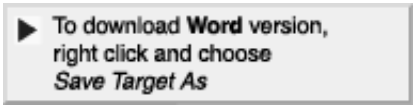
Because the licensee can challenge the validity, enforceability, and scope of a licensed patent by bringing a declaratory judgment action while paying royalties, the licensor should consider including a disincentive for the licensee to do so. One technique is to have a high royalty rate with a discount that applies as long as the licensee does not bring such a lawsuit. An advantage of this technique is that it establishes a higher base rate to use in litigation against an infringer who does challenge the patent validity. Whether or not this approach will survive a court challenge, in view of the U.S. Supreme Court's apparent desire to allow licensees to challenge patent validity (see *MedImmune, Inc. v Genentech, Inc*. (2007) 549 US 118, 166 L Ed 2d 604, 127 S Ct 764), remains to be seen. In short, the licensor and

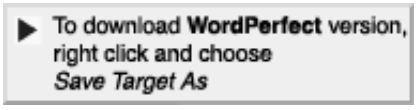
licensee need to be creative in devising license terms that satisfy their business needs.

Several alternative sample royalty rate provisions are set forth in §5.33.

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§5.33 b. Form: Sample Royalty Rate Provisions





5.33-1 Royalty based on net selling price

In consideration for the rights granted under this Agreement, Licensee agrees to pay Licensor the sum specified in Paragraph _ _ above, plus: (a) a running royalty at a rate of _ _[*number*]_ _ percent of the Net Selling Price of Products, said running royalty to be paid within _ _[*number*]_ _ days after each anniversary of the Effective Date during the term of this Agreement; and (b) a lump-sum payment of U.S. $_ _[*amount*]_ _ to be paid within _ _[*number*]_ _ days after the Effective Date of this Agreement. The royalties specified above shall be payable for a period of _ _[*number, e.g., 10*]_ _ years after which the licenses granted herein shall become fully paid up and irrevocable.

5.33-2 Royalty based on cost savings

Licensee shall pay Licensor a royalty of _ _[*number*]_ _ percent of the savings Licensee realizes by implementing the Process versus the current electricity costs. The royalties specified above shall be due throughout the life of the Agreement, and are payable up to a royalty cap of U.S. $_ _[*amount*]_ _, after which the licenses granted herein shall become fully paid up and irrevocable.

5.33-3 Royalty payable for term of patents plus two years

The royalties specified above shall be due at the rate specified in Paragraph _ _ until the last to expire of Patents, and thereafter at a rate of _ _[*number, e.g., 1*]_ _ percent for a period of _ _[*number, e.g., 2*]_ _ years for Licensee's practice of Know-How.

5.33-4 Royalty based on net sales, with exception

Licensee shall pay to Licensor a royalty in United States dollars equal to _ _[*number, e.g., 5*]_ _ percent of Licensee's Net Sales of Articles, except that no royalty shall be due on Licensee's sales of Articles which Licensor manufactures for, or sells to, Licensee.

5.33-5 Royalty consisting of one-time payment

Institution shall pay Artist a one-time payment of U.S. $_ _[*amount*]_ _ on delivery of the painting.

5.33-6 Royalty based on invoice price

Licensee agrees to pay Licensor a running royalty at a rate of _ _[*number*]_ _ percent of the List Price of License Products. The List Price for year 1 shall be $_ _[*amount*]_ _, and for each year thereafter shall be an amount mutually agreed on by the Parties. If the Parties cannot mutually agree on the List Price in any year after year 1, the List Price shall be the List Price for year 1 as adjusted by any change in the Consumer Price Index since year 1.

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§5.34 8. Royalty Term

The license agreement should specify for how long royalties are payable. It is unusual for the term of royalty payments to be longer than the term of the agreement, but it is not uncommon for the term to be shorter than the term of the agreement. For example, a patent license may have a term that expires when the licensed patents expire, but may provide for royalty payments for a shorter term. Examples of term provisions are presented in §§5.75-5.81.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.35 9. Payment Date

§5.35 9. Payment Date

The license agreement should specify when royalty payments are due. For example, an agreement might specify that royalties are payable quarterly, on the last day of the month following the close of each calendar quarter, *i.e.,* April 30 for the quarter ending March 31, July 31 for the quarter ending June 30, and so forth.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.36 10. Place of Payment

§5.36 10. Place of Payment

The license agreement should specify the place where payments are to be made. For example, the amounts may be payable at the licensor's place of business, or the agreement may specify information for payment by wire transfer.

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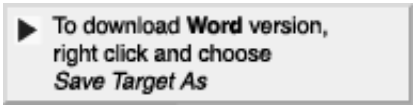
Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.37 11. Currency

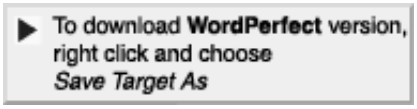
§5.37 11. Currency

Particularly in international transactions, the license agreement should specify the currency in which payments are made. See, *e.g.,* §5.38.

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§5.38 12. Form: Sample Provision for Payment in U.S. Dollars





5.38-1 Sample provision for payment in U.S. dollars

Licensee agrees to make all payments due under this Agreement in United States dollars, provided that such form of payment is consistent with applicable laws. In the case of running royalties, Licensor shall have the option to take such payments in the currency of the countries in which the licenses granted herein are being practiced, the royalty rate being converted to the currency of such countries at the rate of exchange running on the day that payment is made to Licensor. Licensee shall pay all amounts owed to Licensor by wire transfer in immediately available funds, unless otherwise agreed in writing by the parties.

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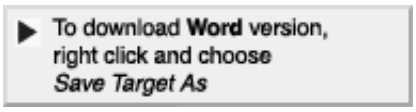
§5.39 13. Taxes

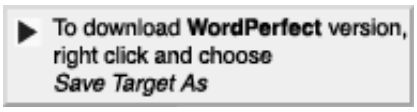
The license agreement may include a provision concerning how taxes are to be handled. See, *e.g.,* §5.40. If taxes are owed on the royalty payments, the agreement may specify that the licensor is to withhold the taxes or that the licensee has the responsibility for payment of taxes.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.40 14. Form: Sample Provision for Payment of Taxes

§5.40 14. Form: Sample Provision for Payment of Taxes





5.40-1 Sample provision for payment of taxes

All payments due to Licensor are net amounts. In the event that any payment due under this Agreement is or becomes subject to any tax or other deduction payable by Licensee, such tax or deduction shall be paid by Licensee, so that the payment to Licensor shall be in full and free of all liability for such tax or other deduction. Licensee agrees to pay and bear the expense of any local, state, or federal government license, sales, use, property, or ad valorem taxes that may be imposed or assessed on Licensee with respect to payments made by Licensee to Licensor under this Agreement. To the extent that any such taxes are imposed by non-U.S governments and are eligible for the U.S. foreign tax credit against Licensor's U.S. federal income taxes, Licensee shall receive a credit in the same amount against its liability hereunder.

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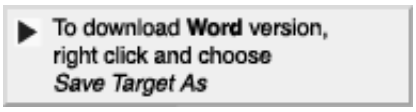
§5.41 15. Effect of Licensing Rights of Third Parties

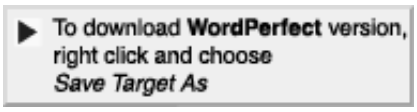
Sometimes the licensee, in order to practice the licensed technology, needs to obtain another license. For example, a third party may have a patent that would prevent the licensee from utilizing the rights granted under the license agreement. In contemplation of such a problem, license agreements often include a provision for reduction of the royalty rate to accommodate payments that need to be made to a third party. See, *e.g.,* §5.42. Without such a provision, one can imagine a situation where there are many owners of the intellectual property relating to a single product and the total royalty payments are therefore so high that it would be impossible to sell the product profitably.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.42 16. Form: Sample Royalty Rate Reduction

§5.42 16. Form: Sample Royalty Rate Reduction





5.42-1 Sample royalty rate reduction if royalties are payable to third parties

If it is necessary for Licensee to pay royalties to one or more third parties to practice the licensed process, the royalty rate shall be reduced by one-half the amount payable to third parties, but in no event shall it be reduced below _ _[*number, e.g., 3*]**_ _ percent.**

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.43 E. Important Business Provisions

§5.43 E. Important Business Provisions

License agreements typically include many important business terms. These should be distinguished from the so-called "boilerplate" terms discussed in §5.82. In general, the terms discussed in §5.82 are desirable to include in an agreement, but not critical. In contrast, most license agreements should include the business terms discussed in §§5.44-5.81.

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§5.44 1. Enforcement of Intellectual Property Rights

There are four principal contractual issues with regard to enforcement of the licensed intellectual property rights against third party infringers: the notice provision (see §§5.45-5.46); who has the right or duty to enforce the intellectual property rights (see §5.47); who pays the costs of the enforcement proceedings (see §5.48); and, if there is any recovery, how it is divided (see §5.49). Three examples of enforcement provisions are presented in §5.50.

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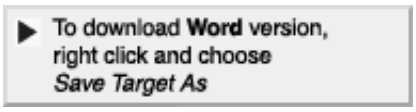
§5.45 a. Notice Provision

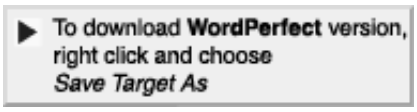
Normally, each party to a license agreement has a duty to notify the other with regard to any infringement of which the first party becomes aware. See, *e.g.,* the sample notice provisions in §5.46.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.46 b. Form: Sample Notice Provisions

§5.46 b. Form: Sample Notice Provisions





5.46-1 Sample notice provision, patent license

Licensee shall notify Licensor in writing of any conflicting uses of, or any applications or registrations for, the technology covered by the grants made in Article _ _, or of any acts of infringement or acts of unfair competition involving Licensor's Patents or Know-How, promptly after such matters are brought to Licensee's attention or Licensee has knowledge thereof.

5.46-2 Sample notice provision, trademark and copyright license

Licensee shall promptly notify Licensor in writing of any actual or reasonably suspected infringement or misuse of any of the Licensed Marks or Licensed Copyrights, and Licensee shall cooperate with Licensor in taking appropriate action to the extent reasonably requested by Licensor.

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§5.47 c. Who Enforces Intellectual Property Rights

Of primary concern regarding enforcement of intellectual property rights is whether either the licensor or the licensee has a duty to enforce or simply a right to enforce. The author recommends against including a duty to enforce unless the license agreement establishes a de minimis standard for infringement. For example, if only a small level of patent infringement is occurring in a venue generally perceived as being difficult and unfavorable to a patentee (such as many Asian countries), it makes little sense to cause the licensor to be in breach of the agreement if the licensor fails to sue the de minimis infringer.

Generally, a license agreement gives only one party the initial right to act against an infringer, and provides an opportunity for the other party to step in if that right is not exercised. For example, the licensee may in the first instance have the right to sue an infringer, with the cooperation of the licensor. If the licensee does not exercise that right, however, the licensor can sue. It is very important, particularly in patent licenses, to grant the licensee an express right to join the licensor in any infringement action. The licensor is generally considered to be an indispensable party, and unless the licensor is made a party to the lawsuit, any lawsuit is subject to dismissal. Another issue is who will control the litigation. Generally, the party who has the first right to bring suit has the right to control the litigation, but it is common to include a provision requiring that the other party be consulted.

In negotiating the enforcement provisions, it is important to bear in mind that it is usually the licensor who has more at stake in litigation against an infringer. For example, if a licensee brings a patent infringement suit and the patent is declared invalid, the licensee loses its exclusivity in the marketplace, but it no longer has to pay royalties—which may be a mixed result from the licensee's standpoint. From the standpoint of the licensor, however, it is a devastating result.

A provision stating that counsel chosen must be acceptable to both the licensor and licensee should be included, because the quality of counsel can affect the outcome.

Consideration should also be given to settlement approval. A settlement in which a licensee stipulates that a licensed patent is invalid is generally not acceptable to the licensor. A settlement by the licensor that allows an infringer to continue infringing on payment of royalties, thereby possibly converting an exclusive license into a nonexclusive license, may not be acceptable to the licensee. Therefore, license agreements often include a provision that both parties must approve any settlement, and that approval cannot be unreasonably withheld.

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§5.48 d. Who Pays

Generally, the party that brings the lawsuit has control of it and pays the litigation costs. If the licensee is responsible for initiating litigation, however, the agreement may include a provision that some or all of the litigation costs will be offset against royalty payments otherwise due, so that, in effect, the licensor will incur at least some of the expenses.

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§5.49 e. How Recovery Is Divided

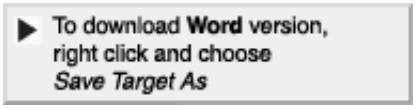
The license agreement should provide for the division of any recovery resulting from litigation. Generally, any recovery first goes to reimburse the licensor or licensee (or both) for the expenses of litigation, on a pro rata basis. For example, if the licensor pays 80 percent of the litigation costs and the licensee pays 20 percent, both are reimbursed for their expenses, and, to the extent that there is a shortfall, they bear the burden of the shortfall in the same ratio. If there is a surplus, the surplus can be divided in a myriad of ways, *e.g.*:

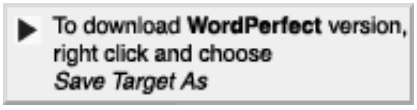
- The surplus is divided pro rata based on the parties' contribution to litigation costs;
- The surplus is divided 50-50;
- The licensor receives the royalties that it would have received if the infringer were licensed, and the licensee receives the remainder on the theory that the remainder is lost profit; or
- The licensee receives the profit that it would have made if it had manufactured the product that the infringer made, and the licensor receives the remainder.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.50 f. Form: Sample Enforcement Provisions

§5.50 f. Form: Sample Enforcement Provisions





5.50-1 Enforcement clause, with suspension of royalty

In the event that any third party shall infringe any claims of Licensor's Intellectual Property, Licensee may, at its option, send written notice thereof to Licensor requesting that Licensor take action to abate such infringement or bring suit against such infringer. Beginning _ _[*number, e.g., 6*]_ _ months from the date of receipt of such notice by Licensor, Licensee may suspend further royalty payments due under any such infringed claims unless and until Licensor shall abate such infringement or bring such suit. In the event infringement is abated or suit is filed, royalty payments shall be resumed, and suspended royalty payments shall become due. Licensor shall not be required to expend more than _ _[*number, e.g., 50*]_ _ percent of any royalties received from Licensee under this Agreement for such infringement action or to prosecute more than one infringement suit at a time in any country.

5.50-2 Alternative enforcement clause, with suspension of royalty

1. In the event that any of the licensed Intellectual Property is infringed by third persons, the party to this Agreement having notice of such infringement shall promptly notify the other in writing, which notice shall set forth the facts of such infringement in reasonable detail.

2. Licensor shall take prompt reasonable steps, including litigation, to abate such infringement, provided that Licensor shall not be obligated to initiate separate litigation against more than one infringer in the United States and no more than two infringers outside the United States at any one time. Licensor shall exercise its best efforts to diligently prosecute such litigation.

3. If Licensor breaches the Agreement by failure to prosecute infringers according to the terms of this Agreement, in addition to any damages for which Licensor may be liable, Licensee shall owe no royalties in those countries in which infringement occurs while such infringement continues and Licensor continues to fail to abate such infringement.

5.50-3 Enforcement clause, recovery to party or parties who institute suit

Licensor and Licensee mutually shall have the right to institute an action for infringement of any of Licensor's Intellectual Property, it being agreed that any such action shall be instituted in the names of both parties and that both parties shall contribute equally to the expense of any such action and shall participate equally in the recoveries, if any, whether by judgment, award, decree, or settlement. It is further agreed that Licensor shall exercise control over such action; provided, however, that Licensee may be represented by counsel of its selection and at its expense. In the event that the parties do not mutually agree to institute such an action, either party may institute such an action and join the other as a party plaintiff. The party so instituting the action shall bear and pay the entire expenses of such action and shall be entitled to retain the entire amount of the recoveries, if any, whether by judgment, award, decree, or settlement.

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§5.51 2. Duty to Exploit

The licensor typically wants the licensee to have some duty to exploit the rights granted. Otherwise, royalties may never become due and the licensor may receive nothing more than the initial payment. One way to assure that there is exploitation is to include a minimum performance requirement, as discussed in §5.19. Other provisions intended to make certain that the licensee exploits the rights granted include:

- Specified performance benchmarks keyed to specific dates, such as due dates for a prototype, a marketing plan, test market introduction, granting of sublicenses, submission to FDA for approval, and FDA approval.
- Financial benchmarks, such as a specified amount to be spent on research and development.
- A best efforts clause, *i.e.,* that the licensee must use its "best efforts" to exploit the intellectual rights granted. This is not a recommended approach, because it is difficult to measure "best efforts" and, if the licensee is incompetent, the licensee's best efforts may be inadequate.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.52 3. Warranties

§5.52 3. Warranties

In addition to the warranties typically found in any agreement, such as the warranty of authority to enter into an agreement, license agreements often contain warranties relating to title (see §§5.53-5.54) and noninfringement (see §§5.55-5.57).

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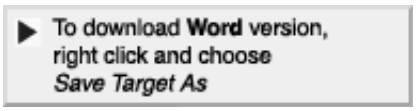
§5.53 a. Warranty of Title

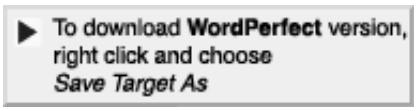
It is common for the licensor to warrant that it has good title to the rights granted. See, *e.g.,* §5.54.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.54 b. Form: Sample Warranty of Title and Authority

§5.54 b. Form: Sample Warranty of Title and Authority





5.54-1 Sample warranty of title and authority

Licensor warrants that it owns the Intellectual Property and that it has the necessary authority to grant the licenses specified in Article _ _.

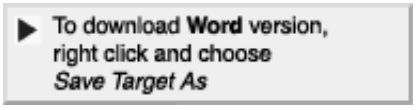
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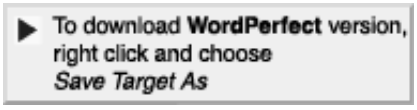
§5.55 c. Warranty (or Disclaimer of Warranty) of Noninfringement

The licensee often requests a warranty of noninfringement or the equivalent. The scope of that warranty should be considered carefully. For example, a broad warranty of noninfringement of any third party's copyright should generally be acceptable to a licensor, because the licensor should know whether or not he or she copied someone else's work. See, *e.g.,* §5.57. A warranty of noninfringement of patent rights, however, is very difficult to give, because without doing a worldwide search, it is impossible to know of all patents that may exist. Moreover, there may be secret pending patent applications that would create infringement problems when the patents are issued. Thus, a warranty with regard to noninfringement of patent rights is generally drafted to state that there is no "known" infringement of any third party rights. For sample disclaimers of warranties concerning patent rights, see §5.56. A warranty regarding noninfringement of a trademark can sometimes be given, but generally only after a comprehensive trademark search.

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§5.56 d. Form: Sample Disclaimers of Warranty





5.56-1 Sample disclaimer of warranty of noninfringement

Licensor makes no warranties with respect to freedom from alleged infringement of third party patents or freedom from third party infringers, and Licensor is not under any obligation to hold Licensee harmless against such alleged infringement of third party patents nor to enforce its patent properties against alleged infringers.

5.56-2 Sample disclaimer of warranty regarding utility of technology

Licensor makes no representation or warranty regarding the commercial utility of technology covered by Intellectual Property Rights.

5.56-3 Sample disclaimer of warranty of patent validity

Licensee understands and agrees that Licensor does not warrant the validity of the patents or the patentability of the patent applications licensed herein. Licensor assumes no liability if, as a result of Licensee's use of the patented process licensed under this Agreement, Licensee should be sued for alleged infringement of any patent not owned or controlled by Licensor, but Licensor shall reimburse Licensee for any sums assessed against and paid by Licensee as a result of any judgment rendered in any such suit, but only to the extent of the royalties previously paid under this Agreement.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.57 e. Form: Sample Warranty of Noninfringement

§5.57 e. Form: Sample Warranty of Noninfringement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

5.57-1 Sample warranty against libel, infringement, invasion of privacy

Artist further warrants that the Master Recordings do not contain any libelous material; infringe any trade name, trademark, trade secret, or copyright; or invade or violate any right of privacy, personal or proprietary right, or other common law or statutory right.

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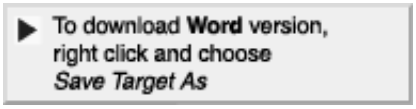
§5.58 4. Indemnification

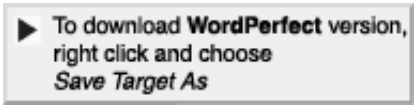
The licensor generally wants indemnification from the licensee that the licensee will defend and hold the licensor harmless in the event that the licensor is sued because of the actions of the licensee. For example, if the licensee infringes a third party's trademark, or uses a third party's trade secrets, or infringes a third party's patent, or causes personal injury or property damage, and the licensor is named in a suit, the licensor wants to be made whole. Likewise, the licensee wants indemnification if there is any breach of any of the warranties made by the licensor. For sample indemnification clauses, see §5.58.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.59 5. Form: Sample Indemnification Provisions

§5.59 5. Form: Sample Indemnification Provisions





5.59-1 Licensee indemnification against licensee's breach or injury or damage caused by licensee

Licensee shall defend, indemnify, and hold harmless Licensor, its successors, assigns, officers, directors, employees, and agents from any and all claims, causes of action, losses, liabilities, and expenses (including, but not limited to, reasonable attorney fees) arising out of any breach of this Agreement by Licensee. Licensee shall defend, indemnify, and hold harmless Licensor, its successors, assigns, officers, directors, employees, and agents from any and all claims, causes of action, losses, liabilities, and expenses (including, but not limited to, reasonable attorney fees) arising out of any personal injury, death, environmental damage, or property damage caused by Licensee, or any defects in design, materials, or workmanship of any kind by Licensee.

5.59-2 Licensee indemnification against injury or damage caused by licensee (alternate)

Licensee agrees to be responsible for and to defend, indemnify, and hold harmless Licensor from any and all claims, loss, damage, or expense by reason of any accident, injuries, damages, or injury to any person or property, including property of Licensor or Licensee, that may occur in connection with or related to the performance of this Agreement, and which is caused in whole or in part by the negligent act or omission of Licensee. This Paragraph shall not include injuries or damage caused solely and directly by the negligent act or omission of Licensor. In the event injury or damage is caused by the joint negligence of Licensor and Licensee, each party shall share the loss arising from such injuries or damage in proportion with its percentage amount of negligence.

5.59-3 Licensee indemnification against infringement, design defects, breach of warranty

***Indemnification by Licensee*. Licensee agrees to indemnify Licensor, its officers, directors, agents, employees, and subsidiaries, and to defend Licensor against and hold Licensor harmless from any and all claims, suits, loss, liability, expense (including costs of suit and attorney fees), and damage arising out of: (a) _ _[*describe*]_ _, except for Licensee's use of the Mark, any alleged infringement or unauthorized use of any patents, copyrights, trademarks, or any other proprietary rights, owned, used, or controlled by third parties arising under or in conjunction with the manufacture, sale, or use of any Articles; or (b) any actions arising out of alleged defects or design defects in the Articles (including those Articles approved by Licensor), regardless of whether the action(s) sound(s) in negligence or strict liability, and regardless of whether the alleged negligence of Licensor is characterized as "passive" or "active"; or (c) any violation of any warranty or guaranty. This indemnification includes, without limitation, all damages, profits, interest, reasonable attorney fees, costs, and expenses in connection with any suit, action, legal proceeding, claim, or demand.**

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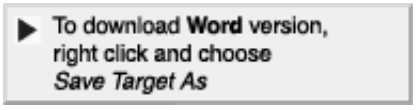
6. Marking

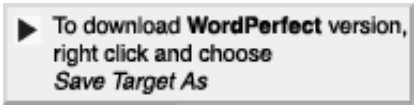
§5.60 a. Importance of Marking

It is important to include a marking provision in the license agreement to protect the licensor's rights and its ability to collect damages in case of infringement. See, *e.g.,* §5.61. Such a provision can include a requirement to use ® in a trademark license or a copyright notice in a copyright license, or to comply with the patent marking statute in a patent license.

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§5.61 b. Form: Sample Marking Provisions





5.61-1 Sample registered trademark marking clause

Licensee shall use the symbol ® for the Licensed Marks that have been registered with the United States Patent and Trademark Office.

5.61-2 Sample general trademark usage clause

Labeling; Advertising. **Licensee agrees that the Mark will appear on or within each Article sold or shipped by it and on or within all advertising, promotional, or display material. Licensee shall put on all Articles, on packages, containers, labels, and other similar items, and on all advertising and promotional materials, such legends, markings, and notices as required by law or regulation in the Territory and as Licensor may request. All Articles shall contain Licensee's identifying Mark so that the origin of the Articles can be determined. Wherever the Mark appears, the designation "TM" or, if appropriate, "®" shall follow.**

5.61-3 Sample patent marking clause

Licensee shall comply with the patent marking statute, 35 USC §282.

5.61-4 Sample copyright notice clause

Licensee shall include a copyright notice on all copies of the Work in the form of "© _ _[*Licensor's name*]_ _ 2008, All Rights Reserved."

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§5.62 7. Reporting and Audits

With an ongoing royalty obligation, it is important that the license agreement specify the licensee's reporting requirements and also the licensor's audit rights. Experienced auditors report that over 99 percent of licensees under-report royalties due because of the absence of penalties for under-reporting. If possible, the license agreement should include penalties to discourage under-reporting, such as an increase in future royalty rates or the right to terminate the agreement if under-reporting is greater than, *e.g.,* 10 percent. The key issues regarding audits are how often they can occur (see §5.63), who conducts them (see §5.64), and who pays for them (see §5.65). Sample recordkeeping and audit provisions are set forth in §5.66.

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§5.63 a. Frequency of Audits

The license agreement should specify how frequently any audit can take place. It is recommended that audits be conducted at least every 2 years. Records necessary for an audit can disappear, even when the license agreement requires that records be kept for a long time. The frequency provision should mention how long records will be maintained. For example, if it makes sense to do an audit every 5 years in view of the amount of money involved, then the licensee should be required to maintain records for at least 5 years.

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§5.64 b. Who Conducts Audit

Often there is a provision specifying who conducts the audit. For confidentiality purposes, the licensee normally wants to limit who can conduct the audit, *e.g.,* a certified public accountant, and to require a confidentiality provision as part of the audit rights.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.65 c. Who Pays for Audit

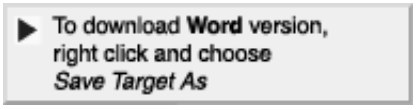
§5.65 c. Who Pays for Audit

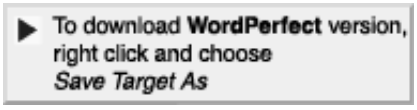
The licensor in the first instance pays for the audit. The licensor may want a provision in the agreement that if there is a shortfall by a certain amount, then the licensee must pay for the audit. A typical shortfall number that is used is anywhere from 3 percent to 10 percent.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.66 d. Sample Recordkeeping and Audit Provisions

§5.66 d. Sample Recordkeeping and Audit Provisions





5.66-1 Sample recordkeeping and audit provision

1. Licensee shall keep accurate and sufficient records to determine amounts owed to Licensor under this Agreement. Licensee shall make a written report detailing the basis for any computations to Licensor at the address specified in Article _ _, within 30 days following each calendar _ _[*quarter or year*]_ _. Along with such reports, Licensee shall transmit payment for the royalty shown to be due. In the event no royalty is due, the report shall so state.

2. Records necessary for the computation of amounts payable by Licensee under this Agreement shall be maintained by Licensee for a period of 5 years following each accounting report due, to include the last accounting report due on termination of this Agreement for any reason. Such records shall be open to inspection by an auditor selected by Licensor to which Licensee has no reasonable objection during regular business hours of Licensee. Such records shall only be used by Licensor or its agents to determine the accuracy of the royalties paid and reports submitted. Licensor shall bear the expenses of the auditor it selects, except that Licensee shall reimburse Licensor for such expenses in the event the total underpayment of royalties identified during the audit exceeds the cost of the audit.

5.66-2 Sample provisions for reporting, recordkeeping, and audit

1. Within _ _[*number, e.g., 30*]_ _ days after the end of each year during the term of this Agreement or renewal period, Licensee shall furnish to Licensor a full and accurate statement showing (i) for Articles purchased by Licensee from third parties, the number, description, and sales price of each Article sold, the gross sales, returns actually received, and the Net Sales of Articles sold during the preceding year, and (ii) for Articles purchased by Licensee from Licensor, the Net Sales of Articles by Licensor to Licensee during the preceding year, together with a check for actual royalties due. The receipt or acceptance by Licensor of any of the statements furnished or of any sums tendered by Licensee shall not preclude Licensor from questioning their correctness at any time.

2. Licensee shall maintain appropriate books of account in which accurate entries shall be made concerning all transactions within the scope of this Agreement. Licensor shall have the right, through any accountant or other authorized representatives of its choice, on reasonable advance notice to Licensee and at no cost to Licensee, to examine and copy all or part of these books of account and all other records, documents, and materials in the possession or under the control of Licensee with respect to the subject matter of this Agreement. All books of account and records shall be kept available by Licensee for at least _ _[*number, e.g., 3*]_ _ years.

3. In addition to its right to inspect, Licensor shall have the right at any time, by its own personnel or its agents, to audit all books and records that Licensee is required to maintain pursuant to this Agreement. In the event an audit discloses that Licensee has understated Net Sales or underpaid royalties for any report period, Licensee shall pay to Licensor the amount, if any, by which the actual royalties exceed royalties paid. If Licensee underpaid royalties by more than _ _[*number, e.g., 5*]_ _ percent, Licensee shall pay to Licensor all reasonable and necessary costs, fees, and expenses incurred by Licensor in conducting that audit. If the royalties paid exceed the actual royalties due, Licensee shall be entitled to a credit equal to the excess.

4. The auditor may consult with Licensor and any of its employees or third party counsel on questions that relate to the Licensed Product and the License Agreement. The auditor may not disclose financial or proprietary information except as required by this Agreement. No other confidentiality agreement will be required to conduct the audit.

5. The right to audit includes the right to interview Licensee's personnel as the auditor determines

appropriate, the right to visit third party manufacturers and sublicensees. Licensee will notify Licensor at least 3 months in advance of any changes in its financial recordkeeping, such as changes of computer software or hardware that could affect the ability of the auditor to conduct an audit.

6. The right to conduct an audit includes, but is not limited to, the right to inspect invoice registers and original invoices, sales analysis reports, accounting general ledgers, sublicense and distributor agreements, price lists, catalogs, marketing materials, audited financial statements, tax returns, sales tax returns, inventory records, and purchase records. If any records are not available so that the auditor cannot determine the actual royalty, the reported royalty or the royalty determined by the auditor, whichever is greater, shall be doubled.

7. Any late royalty payments, including those determined by an audit, shall bear interest at the maximum legal rate.

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8. Assignability

§5.67 a. Right to Assign

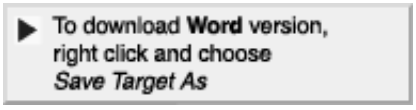
The right to assign the duties and rights of the license agreement should be specified. Unless the licensor has ongoing duties, such as continued research and development efforts, it is common for the licensor to have an unfettered right to assign its rights and duties under the agreement. Generally, the licensor does not want the licensee to have any assignment rights. The reason for this is the licensor's willingness to grant a license and the royalty rate may be dependent on the quality of the licensee. A compromise that is often reached is that the licensee can assign the rights along with a sale of the portion of the licensee's business to which the license is applicable.

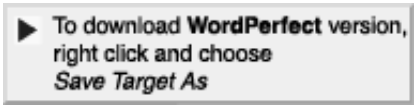
In many instances, the licensee should not be given any assignment rights. See, *e.g.,* the sample clauses prohibiting assignment in §5.68. For example, if a small competitor is licensed, the licensor may not want that license to be transferred to a larger and more aggressive competitor, which could sell into the licensor's markets. In such cases, an assignment clause can include a list of companies to which there can be no assignment, or require that any assignment be subject to the licensor's approval, such approval not to be unreasonably withheld.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.68 b. Form: Sample Nonassignment Clauses

§5.68 b. Form: Sample Nonassignment Clauses





5.68-1 Sample nonassignment clause, with limited release provision

Assignment. **This Agreement may not be assigned by Licensee without the express written consent of Licensor, which consent shall not be unreasonably withheld. The assignment releases Licensee from liability only for those obligations that are assumed by its assignee.**

5.68-2 Sample nonassignment clause, trademark license

Assignability. **Licensee may not assign or sublicense any or all of its rights or delegate any of its duties under this Agreement without the written consent of Licensor. Any attempted assignment or sublicense by Licensee in violation of this provision shall be void. Nothing in this paragraph shall prevent Licensor from assigning the Mark or its rights under this Agreement to a third party as part of the sale of any of the assets of its business or otherwise.**

5.68-3 Sample provision for nonassignment by licensee, assignment by licensor

The license granted herein does not include any right to sublicense, and cannot be assigned by Licensee without the prior written approval of Licensor. Licensor can assign its rights under this Agreement without any approval by Licensee.

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9. Sublicensing

§5.69 a. Right to Grant Sublicenses

Does the licensee have the right to grant sublicenses? If the license is nonexclusive, generally the answer is no because the licensor wants to retain the right to grant additional licenses. If it is an exclusive license, the licensor may be willing to grant the licensee the ability to grant sublicenses. For example, the licensee may be in a better position to exploit the licensed intellectual property rights than the licensor. If the license is a trademark license, the licensee may be granted the right to sublicense use of the mark to third parties for use of the trademark in new product areas within the scope of the original license. Even when the licensee has a right to grant sublicenses, however, the licensor should retain the right to approve any sublicense and the terms of the sublicense agreement, although the approval right should be qualified as not to be unreasonably withheld.

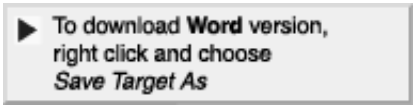
How do the sublicense revenues get divided? The licensor typically wants to receive at least the same amount that it would have received if the licensee had made the sales, but that may not provide any incentive for the licensee to grant sublicenses. A possible compromise is a 50/50 split, with a minimum payment to be received by the licensor.

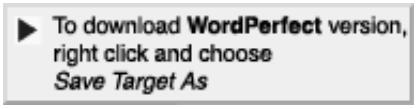
For sample sublicensing clauses, see §5.70.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.70 b. Form: Sample Sublicensing Provisions

§5.70 b. Form: Sample Sublicensing Provisions





5.70-1 Sample sublicense clause subject to field of use limitations

With respect to Products, the right to sublicense granted in Paragraph _ _ above shall be subject to the following Field of Use limitation(s): _ _[*Describe*]**_ _**

5.70-2 Sample sublicense clause, royalty to be shared with licensor

In consideration for the right to sublicense granted to Licensee under Article _ _ above, Licensee shall pay to Licensor a sum equal to _ _[*number*]**_ _ percent of the gross royalty income Licensee receives from sublicensees of Licensor's Intellectual Property after such royalty has been received therefor from each sublicensee by Licensee.**

5.70-3 Unrestricted right to sublicense

Licensor grants Licensee an exclusive right to sublicense others to make, use, and sell under the claims of Patents.

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10. Prohibition on Challenges to Validity and Enforceability of Licensed Rights

§5.71 a. Agreements Not to Challenge

The licensor is likely to include a provision in the agreement prohibiting the licensee, during the term of the agreement, from challenging the validity or enforceability of any of the licensed rights. See, *e.g.,* §5.72. Typically, the licensor's position is that if the licensee wants to challenge validity, it can do so only after terminating the license agreement. As an additional disincentive to such challenges, consideration should be given to provisions that become effective if there is such a challenge, *e.g*.:

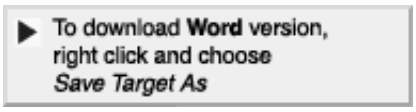
- The royalty rate increases;
- A discount in the royalty rate is lost; or
- The licensee pays for the licensor's attorney fees.

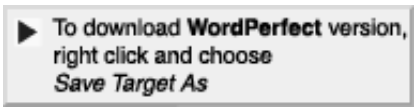
The enforceability of any of these provisions is uncertain at present, particularly with regard to licensed patents.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.72 b. Form: Sample Prohibitions on Challenges

§5.72 b. Form: Sample Prohibitions on Challenges





5.72-1 Licensee not to challenge validity of trademarks or copyrights

Licensee at no time shall challenge the validity of any of the Licensed Marks or Licensed Copyrights, and will cooperate with Licensor in enforcing the Licensed Marks and Licensed Copyrights.

5.72-2 Licensee not to challenge validity of trademarks (alternate)

Licensee will not, during the term of this Agreement or thereafter, use any business name utilizing the Mark or any confusingly similar Mark, attack Licensor's title in and to the Mark, attack the validity of the Mark, attack the registration in any country by Licensor of the Mark, or attack the validity of this Agreement.

5.72-3 Licensee not to challenge validity of patents

Licensee shall not itself challenge, or assist any third party in challenging, the validity or enforceability of the Licensed patents.

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11. "Most Favored Nation" Clauses

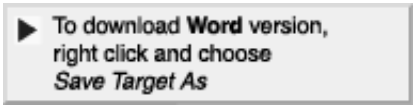
§5.73 a. Drafting Issues

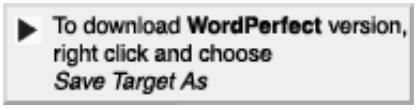
No licensee wants to pay more for its license than any other licensee of the identical technology. A so-called "most favored nation" clause (in this case, a "most favored licensee" clause) is often included in a license agreement to protect the licensee. See, *e.g.,* §5.74. These clauses are difficult to draft and equally difficult to enforce. There can be many negotiated terms in a license agreement, of which the royalty rate is only one. Often, patent licenses include a cross-license, with the result that both parties become a licensor and a licensee. How should the consideration under a cross-license be evaluated? If there is to be a "most favored licensee" clause in such a license, the precise agreement terms to which the clause applies must be specified. In addition, there should be a provision requiring the licensor to notify the licensee if any additional license is granted.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.74 b. Form: Sample 'Most Favored Nation' Provisions

§5.74 b. Form: Sample "Most Favored Nation" Provisions





5.74-1 Sample "most favored nation" clause

In the event Licensor hereafter grants to any third person a license covering the same or substantially the same matters as are covered by this Agreement at royalty rates more favorable to such third person than the royalty rates herein required of Licensee, Licensee may, on written request to Licensor, thereafter have the benefit of such more favorable royalty rates, provided that Licensee also accepts the burden of any less favorable terms that may accompany the more favorable royalty rates.

5.74-2 Sample "most favored nation" clause (alternate)

In the event that Licensor shall at any time hereafter grant or amend licenses under Patents, Know-How, or Confidential Information as licensed herein to a third party to provide a royalty rate more favorable than those set forth herein, _ _[*Licensor agrees to promptly so notify Licensee and Licensee may at its option, exercisable in writing within 60 days after receipt of such notice, obtain/Licensee may, on written request to Licensor, obtain/Licensor shall automatically grant*]_ _ **such more favorable royalty rate for the applicable territory, effective as of the date of the grant to the third party, for as long as such royalty rate is available to that third party; provided, however, that Licensee shall also accept the burden of any less favorable terms that may accompany the more favorable royalty rate, and provided further, that Licensor may assign a fair value to patent rights on then-existing inventions or to other considerations of real value received from that third party in determining the royalty terms available to Licensee. For purposes of this Paragraph, affiliates and subsidiaries of Licensor shall not be construed as being third parties.**

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/ 12. Term and Termination/§5.75 a. Term

12. Term and Termination

§5.75 a. Term

The term of the license agreement must be specified. For patent licenses, the term is often the life of the last patent to expire. For trademark, trade secret, or copyright licenses, however, the term of the license agreement is usually shorter than the life of the licensed rights because trademarks and trade secrets last forever (at least in theory) and copyrights have a very long life. The term may be a specific amount of time with an automatic extension if neither party gives the other a notice of termination within a specified period before the end of the term.

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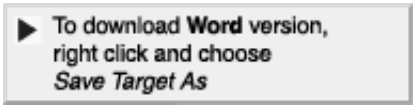
§5.76 b. Voluntary or Involuntary Termination

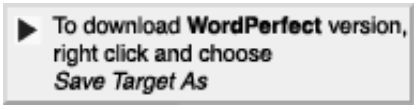
In addition, provisions for termination of the agreement either voluntarily or involuntarily (or both) before the end of the stated term must be specified. See, *e.g.,* §5.77. License agreements commonly provide that a material breach, such as nonpayment of royalties, gives the licensor a right to terminate, with or without a cure period after notice to the licensee. Other events that would trigger termination may include a bankruptcy filing by either party, although the enforceability of such provisions (known as "ipso facto" clauses) under the Bankruptcy Code is doubtful. See §12.13.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.77 c. Form: Sample Termination Provisions

§5.77 c. Form: Sample Termination Provisions





5.77-1 Sample patent license termination clause

Unless otherwise earlier terminated, this Agreement terminates on the first to occur of (a) _ _[*number, e.g., 4*]_ _ years from the Effective Date; or (b) on expiration of the last Patent Rights to expire in the Territory.

5.77-2 Sample provision for termination in event of breach

If either party commits a material breach of any provision of this Agreement and fails to correct such breach within _ _[*number, e.g., 30*]_ _ days after written notice from the other party, the nonbreaching party has the right to immediately terminate this Agreement without prejudice to any legal remedies available. Waiver by the nonbreaching party of its right to cancel this Agreement due to any particular breach of any provisions thereof shall not be construed as a continuing waiver.

5.77-3 Sample termination clause with renewal option

The initial term of this Agreement shall be _ _[*number, e.g., 3*]_ _ years from the effective date of this Agreement, as set forth above. This Agreement shall be automatically renewed for _ _[*number, e.g., 2*]_ _ successive terms of _ _[*number, e.g., 3*]_ _ years each; provided, however, that either party may terminate this Agreement on the renewal date by giving written notice to the other at least _ _[*number, e.g., 90*]_ _ days prior to the date that the Agreement is scheduled to be renewed.

5.77-4 Inventory to be sold on termination

On termination of this Agreement, Licensee has a sell-off period of _ _[*number, e.g., 1*]_ _ month to sell all inventory in its possession, in an amount not to exceed _ _[*fraction, e.g., 1/12*]_ _ of what was sold by Licensee in the last year of the term. Licensee shall destroy any inventory remaining after the sell-off period.

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§5.78 13. Recordation of License Agreement

For exclusive patent, copyright, and trademark licenses, the licensee normally wants to have the ability to record the license with the applicable federal (or state) agency in order to cut off the rights of a bona fide purchaser for value and to protect the licensee's rights in the event of a licensor bankruptcy. See §§12.42-12.45 for discussion of recordation of patent, copyright, and trademark licenses. See also the applicable recording statutes: 35 USC §261 (patents); 15 USC §1060(a) (federal trademarks); Bus & P C §14220 (state trademarks); 17 USC §204(a) (copyrights). Often, the license agreement includes an attachment for recording with the applicable agency. Licenses recorded with the U.S. Patent and Trademark Office or the U.S. Copyright Office must be accompanied by official cover sheets, available for downloading on each agency's website. Sample cover sheets are reproduced in §§8.7 (patent cover sheet), 8.10 (trademark cover sheet), and 8.14 (copyright cover sheet).

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§5.79 14. Invalidity of Rights Licensed

Provisions addressing what happens if any of the licensed rights are determined to be invalid are often included. For example, if all licensed patents are declared invalid, the obligation to pay royalties may be suspended or eliminated. See, *e.g.,* §5.80. Such a provision should specify when a right is invalid for purposes of the agreement, *e.g.,* the invalidity may be operative as soon as a court renders a decision, or the provision may require that the decision be unappealable.

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§5.80 15. Form: Termination of Royalty on Invalidity

5.80-1 Royalty obligation ends if patent invalid

If any claim of any patent within Licensor's Patents shall be declared invalid by a final judicial decision, Licensee shall thereafter be under no obligation to pay royalties for Licensee's operation under such claim unless the Licensee's operation is dominated by one or more claims of Licensor's Patents not declared invalid.

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§5.81 16. Defense of Infringement Suits

What if the licensee is sued for infringement as a result of exercise of the rights granted by the licensor? The license agreement should include a provision addressing who has control of the defense and who pays for it. See §§5.58-5.59 regarding indemnification clauses for defense of infringement suits.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.82 F. Standard Provisions ('Boilerplate')

§5.82 F. Standard Provisions ("Boilerplate")

Like other agreements, license agreements routinely include standard, so-called "boilerplate" provisions. For examples of such provisions, see Drafting Business Contracts: Principles, Techniques & Forms (Cal CEB 1994). The subjects of typical "boilerplate" provisions include the following:

- Choice of law;
- Venue;
- Jurisdiction;
- Alternate dispute resolution (particularly recommended for trade secret license agreements to avoid disclosure, and resulting loss, of the trade secrets in public litigation proceedings);
- Integration;
- Force majeure;
- No agency;
- Headings for convenience only;
- Execution (*e.g.,* whether scanned or facsimile signatures are satisfactory);
- Notice (specifying where and how notices under the agreement are to be sent);
- Waiver of breach (*e.g.,* that waiver of one breach is not a waiver of all breaches);
- Injunction availability (*e.g.,* whether injunctions are available to enforce rights);
- Bankruptcy (specifying what happens if either party files bankruptcy); and
- Limitations of liability (and if there are indemnification clauses, dollar limitations on liability).

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§5.83 III. SPECIAL PROVISIONS

Certain provisions of license agreements are unique, depending on the type of intellectual property rights that are licensed. Sections 5.84-5.109 discuss the special provisions that are necessary or desirable in licenses of inventions (*i.e.,* patents and patent applications; see §§5.84-5.92), trade secrets (see §§5.93-5.96), trademarks (see §§5.97-5.101), and copyrights (see §§5.102-5.109)).

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A. Invention Licenses (for Patents and Patent Applications)

§5.84 1. Prosecution and Maintenance Fees

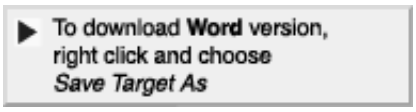
A provision specifying who is responsible for the prosecution of any pending patent applications and payment of the associated costs may be included in the agreement. If the licensee's obligation to pay royalties depends on successful prosecution of a patent application, it is generally recommended that the licensor-owner of the patent rights have principal responsibility for prosecution. The licensee does not wish to be subject to an accusation that it "sabotaged" the prosecution of patent applications to avoid paying license fees.

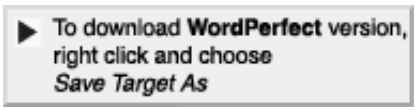
In the United States, ongoing patent maintenance fees are payable to the U.S. Patent and Trademark Office. In the absence of any contrary provision, the licensor is responsible for such fees. Many times, however, the licensee wants to assure that the fees are paid and therefore assumes that responsibility. Alternatively, the agreement may provide that the licensor is required to notify the licensee if the licensor decides to abandon any pending application or to stop payment of maintenance fees, in order to give the licensee an opportunity to step in and take over prosecution and payment of maintenance fees. See the examples in §5.85.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.85 2. Form: Sample Provisions for Maintenance

§5.85 2. Form: Sample Provisions for Maintenance





5.85-1 Licensor to maintain licensed patents

It is understood that Licensor is not required to maintain any patent or patent application. Nonetheless, until Licensor notifies Licensee otherwise, Licensor is responsible for prosecuting those patent applications that are part of the Patents and maintaining patents that result from such applications and the patents that are included in the Patents.

5.85-2 Cost reimbursement by licensee

Licensee agrees to reimburse Licensor for all necessary costs in maintaining any patent or patent application included in the Patents.

5.85-3 Licensor to notify licensee of any change in status

Licensor shall notify Licensee of any change in status of patents or patent applications included in the Patents. If Licensor elects not to continue prosecution of any patent application or to maintain any patent included in the Patents, Licensor shall promptly notify Licensee in writing and grant Licensee the right to continue patent prosecution or to maintain any such patent. All costs incurred by Licensee in continuing prosecution or in maintaining such patents shall be deducted from the royalty payments due to Licensor by Licensee under Article _ _ hereof.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.86 3. Improvements

§5.86 3. Improvements

The parties should consider and address in the license agreement two types of potential improvements to the licensed inventions: improvements made by the licensor and those made by the licensee. The issues concerning how the improvements are to be handled are the same in each case.

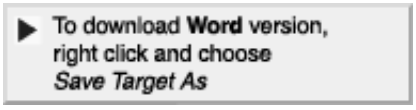
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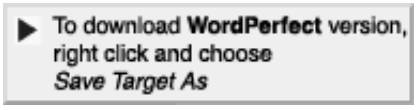
§5.87 a. Ownership

The parties need to specify who owns the improvements. Usually, the party who made the improvement owns them in the first instance, but grant-back clauses are common, particularly when there are multiple licensees, under which the licensor either obtains ownership of the improvements or receives a license with a right to grant sublicenses. If there are multiple licensees, it is advantageous to have the licensor obtain rights to any improvements. That way, each licensee through grant-back clauses can enjoy the benefits of any improvement made by another licensee. For examples, see §5.88.

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§5.88 b. Form: Sample Provisions Regarding Improvements





5.88-1 Licensee to assign improvements to licensor

Licensee and each person under Licensee's control using, making, or selling the Licensed Technology agrees to assign to Licensor any and all rights to improvements on the subject matter claimed in the Licensed Patents developed during the Term of this Agreement.

5.88-2 Licensor has first right of refusal over improvements

When Licensee has determined to grant an exclusive license under a Licensee Improvement, Licensee shall first offer the license to Licensor and, in the event that Licensor fails to accept the offer within _ _[*number*]_ _ days, Licensee will be free to offer the license to any third party on terms no more favorable to that third party than those offered to Licensor. When Licensee has determined to grant nonexclusive licenses under a Licensee Improvement, Licensee shall notify Licensor, and, at any time on Licensor's request, shall grant to Licensor a nonexclusive license to make, use, and sell the claimed invention(s) of such Licensee Improvement. All such nonexclusive licenses shall be on terms and conditions no less favorable than have been, or are thereafter, offered to any third party; and in the event that no previous licenses have been granted, the licenses to Licensor shall be for a reasonable royalty.

5.88-2 Grant-back clause giving licensor nonexclusive license to improvements

Should any patentable development(s) relating to Licensor's proprietary information and samples transmitted to Licensee be made by one or more employees of Licensee during tests carried out hereunder or as a direct consequence thereof, and should any patents be obtained by Licensee covering such Licensee developments, Licensee shall grant licensor a royalty-free, nonexclusive license throughout the world to practice the claimed invention(s) with a right to extend to Licensor's customers a right to practice the same.

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§5.89 c. Inclusion of Improvements in License Grant

If the licensor makes improvements, do they become part of the license grant? Further, if the licensor obtains any other related patent rights or improvements, either from another licensee or by acquisition, do those additional rights or improvements become part of the license grant? The license agreement should address these questions.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.90 d. Effect on Term, Royalty Base, and Royalty Rate

§5.90 d. Effect on Term, Royalty Base, and Royalty Rate

If the improvements are to be included in the license grant, the license agreement should address the effect, if any, on the term of the license agreement and the royalty base and royalty rate.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.91 e. Maintenance Fees for Improvements

§5.91 e. Maintenance Fees for Improvements

Just as there should be a provision regarding prosecution and maintenance fees for the patent rights initially licensed (see §5.85), the license agreement should also provide for prosecution and maintenance fees for any improvements.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.92 4. Warranties of Validity, Enforceability, and Utility

§5.92 4. Warranties of Validity, Enforceability, and Utility

The licensee may require the licensor to give warranties regarding the validity, enforceability, and utility of the licensed patent rights. The licensor should seek to limit the scope of the warranty regarding validity to the "knowledge of" the licensor. There may be prior art of which the licensor has no knowledge but which could affect the validity of the patent rights granted. Because unenforceability is often the result of misconduct by the licensor in the U.S. Patent and Trademark Office, a broad warranty of enforceability is more common than a warranty of validity. There are very few inventions that lack utility, so in most cases the licensor should be willing to give the licensee a warranty of utility.

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B. Trade Secrets

§5.93 1. Steps to Control Secrecy

Trade secrets have value only as long as they are maintained secret. See CC §3426.1(d). Therefore, it is advisable from the licensor's standpoint to include provisions in the license agreement regarding how the licensee is to maintain secrecy of the trade secrets. See, *e.g.,* §5.94. For example, confidentiality provisions may include a requirement to mark documents "Confidential," limitations on the parties who have access to the licensed trade secrets, and a requirement that employees sign satisfactory confidentiality agreements. For further discussion of trade secret protection, see §§6.27-6.34.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.94 2. Form: Sample Confidentiality Clause

§5.94 2. Form: Sample Confidentiality Clause

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

5.94-1 Sample confidentiality clause

Licensee agrees to maintain Confidential Information in confidence using the same degree of care as Licensee takes to safeguard its own proprietary information of the same general nature, but in no event shall Licensee use less than a reasonable degree of care. Licensee shall refrain from disclosing Confidential Information to others during the term of this Agreement and for a period of _ _[*number, e.g., 5*]_ _ years after termination of this Agreement.

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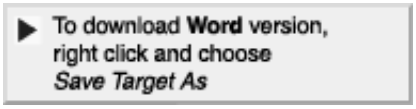
§5.95 3. Transfer of Trade Secrets

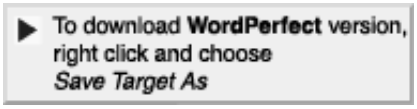
A trade secret license agreement should include provisions for transfer of the licensed trade secrets and know-how. For example, trade secrets may be provided in documents marked "confidential," or an employee of the licensor, with expenses paid, may be assigned to spend a certain amount of time training designated employees of the licensee. See, *e.g.,* §5.96.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.96 4. Form: Sample Provision for Licensor's Disclosure of Information to Licensee

§5.96 4. Form: Sample Provision for Licensor's Disclosure of Information to Licensee





5.96-1 Licensor disclosure, instruction, furnishing of technician to licensee

Licensor shall disclose to Licensee existing information regarding the Process and instruct Licensee's representative(s) in the necessary procedures for practicing the Process. On request, Licensor shall furnish to Licensee the services of an experienced technician, if available, to advise and instruct Licensee in the operation of the Process, but reserves the right, on prior written notice to Licensee, to charge for such services at the rate of U.S. $_ _[*amount*]_ _ per technician day, including travel time, plus reasonable travel and living expenses for the time during which the technician is so engaged.

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C. Trademarks

§5.97 1. Quality Control

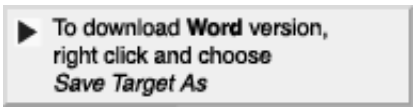
A trademark license that does not include quality control provisions may result in abandonment of the licensed mark. See §6.22. Thus, it is essential to include some quality control provisions in any license agreement. See, *e.g.,* §5.98. For example, quality control provisions may include one or more of the following:

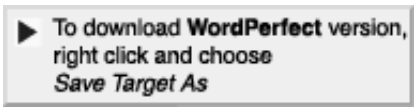
- Right of the licensor to randomly inspect the licensed product or services;
- Requirement that the licensee provide representative sample products to the licensor;
- Requirement that the quality of the licensee's products or services be at least as good as the licensor's.

Franchise agreements, which generally include trademark license provisions, typically have detailed quality control provisions.

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§5.98 2. Form: Sample Quality Control Provisions





5.98-1 Quality standards, licensor's inspection right

Licensee shall use the Licensed Marks only in conjunction with services of the quality typical in the industry and according to such other standards set from time to time by Licensor. Licensor shall have reasonable access to and shall have the right to inspect all facilities managed by Licensee to ascertain the quality of the services provided by Licensee under the Licensed Marks. In the event that the quality of services provided by Licensee under the Licensed Marks is deemed inadequate by Licensor, Licensor shall so notify licensee in writing. If the services provided by Licensee are not then improved to a level satisfactory to Licensor within 60 days, Licensor may terminate this Agreement.

5.98-2 Quality standards (alternate)

Licensee acknowledges that its use of the Mark on, and in connection with the manufacture by or for it, promotion and sale of the Articles shall at all times be subject to the approval of Licensor. All Articles shall be of high and merchantable quality and of at least the same quality as products manufactured by Licensor. All Articles will be manufactured, sold, and distributed in accordance with all applicable national, state, and local laws.

5.98-3 Licensor's approval rights

Before offering any Article for sale, Licensee shall obtain Licensor's approval. To obtain Licensor's approval of an Article, Licensee shall provide Licensor with at least one final sample. Licensor shall indicate its approval or disapproval of the sample in writing which shall be mailed within _ _[*number, e.g., 10*]**_ _ business days following Licensor's receipt of the sample. Once an Article has been approved, it shall not be changed or altered without Licensor's prior approval. Any Article not disapproved by Licensor within _ _**[*number, e.g., 15*]**_ _ business days after receipt by Licensor shall be deemed approved.**

5.98-4 Delivery of samples to licensor

In order for Licensor to determine that Licensee is maintaining quality control standards, within _ _[*number, e.g., 2*]**_ _ weeks after the commencement of the first production run of each Article, Licensee shall deliver to Licensor one exemplar of each finished Article without charge. Licensee acknowledges that Licensor has the right to use these Articles in any manner that Licensor deems beneficial to the positive exploitation of the Mark.**

5.98-5 Licensor's right to inspect

On reasonable notice, Licensor shall have the right to inspect, without limitation, the plants, factories, and other manufacturing facilities of Licensee and any third parties where the Articles or components used in making Articles are being manufactured or produced by or for Licensee. The methods of inspection shall include any reasonable actions, including, without limitation, the use of laboratory testing and inspection of piece goods. Licensor's representatives shall have the right to take any other action that, in the Licensor's opinion, is necessary or proper to assure Licensor that Articles are made in accordance with the requirements of this Agreement.

5.98-6 Licensee's agreements with other manufacturers

If the Articles or components are manufactured other than by Licensee, Licensee shall obligate the manufacturer to the applicable conditions of this section. All such agreements shall be in writing, ensure high quality, prevent resale of seconds, and protect the Mark. Licensee shall provide all such agreements with

manufacturers to Licensor for approval before entering into such agreements. All agreements referred to in this subparagraph shall be deemed approved unless disapproved by Licensor in writing within 10 days of receipt.

5.98-7 Testing, labeling, licensor's approval rights

Licensee shall pre-test all Articles. Licensee shall label the Articles, including, if applicable, information about the care, maintenance, and use of the Articles. Licensee shall inform Licensor about, and shall promptly correct, any complaint by a consumer or governmental body relevant to the Articles. The quality, design, fabrication, and style of all Articles, and of all cartons, containers, tags, labels, and packing or wrapping material to be used in connection with the Articles by Licensee shall be subject to the approval of Licensor. Before sale or distribution, Licensee shall furnish Licensor (free of cost) with at least three exemplars of each carton, container, tag, label, and packing and wrapping material. Any item submitted to Licensor shall be deemed approved unless disapproved by Licensor in writing within _ _[*number, e.g., 10*]_ _ days of receipt. Any disapproval notice shall specify all objections. Licensee shall not use any items not approved by Licensor. After exemplars have been approved, Licensee shall not make any material change without Licensor's prior approval.

5.98-8 Licensee's use of licensed trademark

Licensee shall take such reasonable steps as are necessary to maintain the Articles as a separate and distinct line in graphic design, merchandising, and packaging from any other product manufactured, sold, or distributed by Licensee. Licensee shall not use the Mark, or any graphic designs used or associated with the Mark, in connection with any article or service of Licensee, except for the Articles. Licensee shall not use, nor allow the use of, the Mark or designs in connection with any nonlicensed product or service provided by Licensee, its officers, employees, or affiliated business entities. Licensee shall not combine the licensed mark with any mark of licensee in a manner that compromises the separate character of the Mark.

5.98-9 Defective goods, use of licensed trademark

Licensee shall not sell any "seconds," damaged goods, imperfect goods, non-first-quality goods, or defective goods except as Licensor and Licensee shall agree in writing. All seconds not sold in an agreed manner shall be destroyed. Licensee shall use the Licensed Marks in accordance with instructions provided from time to time by Licensor, and shall submit to Licensor for approval all uses of the Licensed Marks; provided, however, that no such consent shall be required in connection with the use of Licensed Marks consistent with past use by Licensee.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.99 3. Benefit of Use Accrues to Trademark Owner

§5.99 3. Benefit of Use Accrues to Trademark Owner

The license agreement should be clear that any use of the trademark by the licensee is on behalf of the trademark owner and that the licensee acquires no rights in the trademark other than those specified in the license agreement. See, *e.g.,* §5.100.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.100 4. Form: Sample Acknowledgement of Licensor's Rights

§5.100 4. Form: Sample Acknowledgement of Licensor's Rights

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

5.100-1 Use of trademark inures to benefit of licensor

Licensor acknowledges Licensor's title to the Licensed Marks, and agrees that all use of the Licensed Marks shall inure to the benefit of Licensor. Licensor shall not do anything that would in any way impair the rights of Licensor.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.101 5. Franchise Avoidance

§5.101 5. Franchise Avoidance

Both the federal government, through the Federal Trade Commission, and many states, including California, have laws regulating franchises. Under California law (see Corp C §31005(a)), there are four elements necessary for an agreement to constitute a "franchise":

- A right must be granted to the franchisee to engage in the business of offering, selling, or distributing goods or services;
- The right must be granted to engage in the business under a marketing plan or system prescribed in substantial part by the franchisor;
- The operation of the franchisee's business must be substantially associated with an advertising or other commercial symbol designating the franchisor or an affiliate of the franchisor, such as a trademark, service mark, trade name, or logotype; and
- The franchisee must be required to pay, directly or indirectly, a fee or charge, known as a "franchise fee," for the right to enter into the business.

Further discussion of the franchise laws and the issue of when a trademark license agreement falls within the definition of a "franchise" is beyond the scope of this title. The license agreement should be drafted to avoid application of the franchise laws unless the parties are prepared to comply with them. Under California law, among other things, if the license agreement does qualify as a "franchise" and no exemption is available, it is necessary to register the document with the Department of Corporations in advance, much like a securities offering. See generally Corp C §§31110-31114; http://www.corp.ca.gov/SRD/franchise.asp.

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D. Copyrights

§5.102 1. Rights Granted

A copyright consists of a bundle of rights, including the rights of reproducing, distributing, preparing derivative works based on the copyrighted work, and, in specified instances, publicly performing and publicly displaying the copyrighted work. See 17 USC §102. See also §6.24. These rights can be subdivided. For example, if the work is a book, the following rights can be given to different licensees: publication in hardcover, publication in paperback, publication as an e-book, magazine excerpt rights, and film rights. Copyright licenses are commonly limited to cover only certain specified rights, with other rights subject to different licenses with other licensees.

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§5.103 2. Software Licenses

A software license normally includes a license of copyright. It may also include a license of trade secrets and patent rights. Sections 5.104-5.109 briefly highlight some of the considerations in preparing a software license. For further discussion of software licenses, including a sample form, see Internet Law and Practice in California, chap 12 (Cal CEB 2004).

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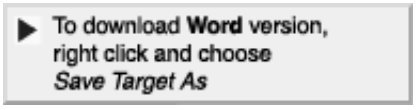
§5.104 a. Source Code Escrow

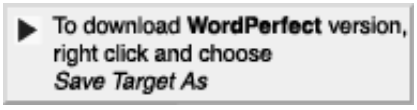
What happens to the licensee if the licensor goes out of business or no longer supports the software provided? To prepare for that possibility, software licenses sometimes include an escrow provision, under which the source code is escrowed with a third party escrow holder. In certain specified circumstances, the licensee receives access to the source code. See, *e.g.,* §5.105. For further discussion of source code escrows, including another longer form of escrow agreement, see §§7.24-7.25. See also the sample forms in §§12.80-12.81 and Internet Law and Practice in California, chap 15 (Cal CEB 2004).

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.105 b. Form: Sample Source Code Escrow Provision

§5.105 b. Form: Sample Source Code Escrow Provision





5.105-1 Source code escrow

Developer hereby appoints Escrow Agent, and Escrow Agent hereby accepts such appointment, to act as escrow agent pursuant to this Agreement and to receive and hold in trust the Source Code for the Software Program on the terms and conditions set forth in this Agreement. Escrow Agent shall hold the Source Code in escrow and shall not deliver the same to the Licensee except following notification from the Licensee that a Delivery Event (as defined below) has occurred and all other terms and conditions of this Agreement have been met. On receipt of such written notice from the Licensee that a Delivery Event has occurred, the Escrow Agent shall immediately forward such notice to the Developer. The Developer shall have a period of _ _[*number, e.g., 10*]_ _ days following the receipt of such notice to notify the Licensee in writing that Developer objects to the release of the Source Code to the Licensee. In the event that the Developer has not given written notice of objection within _ _[*number, e.g., 10*]_ _ days after its receipt of the notice from Escrow Agent, Escrow Agent shall presume that the release of the Source Code is proper and shall immediately deliver the Source Code to the Developer.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.106 c. Restrictions on License

§5.106 c. Restrictions on License

Software license grants often are very restricted. For example, a license may be limited to use by a licensee at a particular site, or in a particular manner, or by a limited number of users. A license can also be limited by prohibiting any reverse engineering.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.107 d. Maintenance; Modifications, Enhancements, and Updates

§5.107 d. Maintenance; Modifications, Enhancements, and Updates

Software often contains bugs, and is constantly being modified, enhanced, and updated. License agreements typically specify the licensee's right to have the software maintained by the licensor, as well as the right to any modifications, enhancements, or updates. The agreement should specify the cost, if any, associated with updates.

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§5.108 e. Installation and Training

Software intended for business or technical use normally requires expert installation and training of personnel. The license agreement should set forth provisions addressing these issues. For comparable provisions in a license of trade secrets, see §§5.95-5.96.

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§5.109 f. Warranties

It is common for copyright licenses to include a warranty by the licensor that there is no violation of privacy and publicity rights. See §5.57.

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§5.109A g. ALI Software Contract Principles

On May 19, 2009, the American Law Institute (ALI) approved the proposed final draft, dated March 16, 2009, of the Principles of the Law of Software Contracts (Principles), copies of which are available for purchase at http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=121. According to the Introduction, the Principles "seek to clarify and unify the law of software transactions" (Principles, at 2) in view of the failure of the Uniform Computer Information Transactions Act (UCITA) to win general acceptance and the general inapplicability of Article 2 of the Uniform Commercial Code to software transactions. The Principles were not intended to be a restatement of the law, but rather to "account[] for the case law and recommend[] best practices." (Principles, at 2). The Introduction clarifies that the Principles "are not the law unless and until a court adopts [them]. Courts can apply the Principles as definitive rules, as a 'gloss' on the common law, UCC Article 2, or other statutes, or not at all as they see fit." Principles, at 2.

The Principles consist of 31 separate sections with accompanying comments, divided into four chapters addressing many topics as follows:

- Chapter 1: Definitions, scope, and general terms (including provisions on unconscionability; choice of law; and choice of forum).
- Chapter 2: Formation and enforcement (including provisions on standard-form transfers of generally available software; enforcement of the standard form; and contract modification).
- Chapter 3: Performance (including provisions concerning implied indemnification; express and implied warranties; the parol-evidence rule and its interpretation; and breach).
- Chapter 4: Remedies (including provisions on agreements to modify or limit remedies; liquidated damages; use of automatic disablement to impair use; and remedies in the absence of agreement).

The Principles are intended to apply to agreements for transfer of software for consideration, including agreements to sell, lease, license, access, or otherwise transfer or share software. Principles §1.06(a). The Principles do not cover digital art, databases, or other media content; do not cover security interests (Comment a to Principles §1.06); and may or may not cover embedded software depending on the circumstances (Principles §1.07).

A detailed analysis of the Principles is beyond the scope of this chapter, but one particularly controversial provision bears noting. Section 3.05(b) sets forth a purportedly nondisclaimable implied warranty that a transferor that receives money or a right to payment in money in exchange for software warrants "to any party in the normal chain of distribution that the software contains no material hidden defects of which the transferor was aware at the time of the transfer." Both Microsoft Corporation and the Linux Foundation, along with other software licensors, objected to §3.05(b), as likely to provoke significant litigation without benefiting licensees. Many forms of software license agreement now include blanket disclaimers of the applicability of UCITA to the transaction. At least until there is some judicial clarification of the Principles in reported case decisions, counsel for software licensors may consider including disclaimers of the applicability of the Principles in their form agreements.

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Source: Business Law/Intellectual Property in Business Transactions/5 Intellectual Property Licensing/§5.110 E. Bankruptcy-Related Provisions

§5.110 E. Bankruptcy-Related Provisions

Chapter 12 provides a detailed discussion of issues that arise when a licensor or a licensee of intellectual property rights becomes a debtor in a bankruptcy case. See §§12.73-12.82 for sample license agreement provisions that should be considered if one of the parties to the license agreement is at risk of bankruptcy.

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6

Joint Ventures and Strategic Alliances

Louis R. Dienes

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§6.1 I. INTRODUCTION

Many new businesses are organized for the purpose of exploiting intellectual property rights. Often, a company requires additional resources—such as capital, management, technological expertise, or manufacturing and distribution capacity—that are necessary or useful for successful exploitation of its intellectual property. The company therefore creates a new legal relationship with one or more parties to provide a framework for contribution of the needed resources by others and exploitation of intellectual property.

The parties' new legal relationship will generally fall into one of two categories. In the first category, a joint venture, the parties form a separate entity—a corporation, limited liability company, partnership, or other legal entity—and share ownership. This legal relationship is often desirable when new intellectual property will be contributed to a new entity that will have an extended existence of its own and when the new entity is not directly competitive with its owner entities. A new business entity is also desirable if the parties include investors who will contribute capital to the new enterprise, but will not necessarily participate actively in the new business's day-to-day management and operations. This type of legal relationship may be costly to form because it involves the formation of a new legal entity with its own operational, governance, equity, and liability structure, as well as tax and accounting issues that need to be considered. If the entity is formed as a general partnership or joint venture under state law, each party may assume liability for the debts and liabilities of the entity. See §6.74. New joint venture entities are often formed for international distribution of products or services, manufacturing, development of new intellectual property, or other collaborative activities. Joint ventures are discussed in §§6.3-6.44. A sample form of joint venture agreement is presented in §§6.45-6.62.

The second category of legal relationship for joint exploitation of intellectual property is a contractual relationship that does not involve formation of a new legal entity. These relationships are often referred to as strategic alliances and other names such as collaboration agreements, joint development agreements, co-marketing agreements, or revenue-sharing agreements—in each case suggesting features of the underlying relationship. These contractual relationships may take many forms, ranging from the brief and informal to the long-term and complex, depending on the parties' objectives. In general, they are more flexible and dynamic than a new joint venture entity, because the parties can amend the terms of their relationship as it matures and potentially terminate their relationship more easily. Exiting does not involve the dissolution and unwinding of a separate legal entity. Contractual relationships can be entered into for a wide variety of purposes, ranging from joint research and development to co-marketing and co-branding of products and services. In these alliances, the parties join forces with a common goal that neither may be pursuing separately, and each party benefits from the resources that the other party brings to the relationship. Contractual collaborations are discussed in §§6.63-6.76. A sample form of strategic alliance is presented in §§6.77-6.92.

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§6.2 II. KEY ISSUES IN STRUCTURING NEW VENTURES

Regardless of the form selected for their relationship, the parties' core agreements will articulate their individual goals and allocate each party's responsibility, risk, and return. Key issues involved in exploring and structuring the new venture include:

- Purpose and anticipated term of the venture;
- Respective roles and allocation of responsibilities of the parties;
- Governance, decision-making, and resolution of deadlock;
- The parties' initial and ongoing contributions to the venture (in cash, tangible property, staffing, management, advertising credits, intellectual property, or other forms);
- The manner of contribution of intellectual property rights, *i.e.,* an outright grant or assignment, or a license;
- Allocation of expenses and revenues from the venture between the parties;
- Antitrust issues, particularly when the prospective principals are major existing or potential competitors;
- Bankruptcy—addressing what happens if a principal files a bankruptcy case;
- A software or other technology escrow to protect one party against the failure of the other to perform or to continue to maintain key items of software owned by the first party and licensed to the joint venture;
- Allocation of ownership of intellectual property created in the venture;
- Potential liabilities of the parties, contractual limitations on liability, indemnification;
- Exit strategy, ideally tied to a clear definition of success and failure of the venture based on milestones and measurable metrics;
- Eventual distribution of intellectual property rights and other assets on termination of the venture;
- Tax considerations, especially if the transaction is cross-border or if a new entity is being formed; and
- Export restrictions on any applicable software, encryption, or other technology.

For further discussion of the major considerations in intellectual property collaborations, see §§3.34-3.38. See also Braun & Levine, *Documenting Corporate Joint Ventures*, 22 CEB Cal Bus L Prac 78 (Summer 2007). An illustrative term sheet for a collaboration is presented in §3.61.

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§6.3 III. JOINT VENTURES

Intellectual property-focused joint ventures are often organized as new legal entities—in the United States generally as corporations, limited liability companies, or partnerships. Each of these forms has advantages and disadvantages for the parties seeking to exploit intellectual property rights, and counsel should consider each alternative. In this process, it is essential for the practitioner to consult experienced tax counsel, because tax considerations most often drive the ultimate choice of entity.

NOTE: This chapter presents only a very brief survey of some of the issues relating to the selection and formation of new business entities. For comprehensive discussion of this subject, including formation of corporations, limited liability companies, and partnerships, readers should consult Selecting and Forming Business Entities (2d ed Cal CEB 2007), Organizing Corporations in California (3d ed Cal CEB 2001), Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007), and Advising California Partnerships (3d ed Cal CEB 1999).

In addition to tax matters and the other issues concerning choice of entity discussed in §§6.4-6.14, the parties forming a new joint venture entity should consider (among other things) securities law issues (see §6.15), contribution of intellectual property rights (see §§6.16-6.36), employment matters (see §§6.37-6.40), potential competition (see §§6.41-6.43), and exit strategies (see §6.44).

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A. Choice of Entity

§6.4 1. Corporations

Although limited liability companies are often preferred for intellectual property-focused joint ventures in the United States, corporations remain a popular form of business organization. Corporations offer the advantages of limited liability, a high level of certainty regarding the legal consequences of the organizational form, well-understood management provisions, and general acceptance within the business community. Except as discussed in §6.6, corporations are not appropriate if the founders wish to take advantage of pass-through treatment of tax benefits.

Some key features of the corporate form are discussed in §§6.5-6.8. For comprehensive discussion of the process of incorporation of a business, see Organizing Corporations in California (3d ed Cal CEB 2001); Selecting and Forming Business Entities, chap 9 (2d ed Cal CEB 2007); Corporations Committee of the Business Law Section of the State Bar of California, Handbook for Incorporating a Business in California (2006).

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§6.5 a. Limited Liability

One significant advantage of the corporate form is that shareholders are not individually liable for corporate debts and obligations unless they guarantee corporate debts, engage in tortious conduct, receive improper distributions, become subject to "alter ego" claims, or breach duties to other shareholders or the corporation. See *Postal Instant Press, Inc. v Kaswa Corp.* (2008) 162 CA4th 1510, 77 CR3d 96 (third party creditors may not pierce corporate veil to access corporate assets to satisfy shareholder's personal liability). Under the alter ego doctrine, a court may disregard the corporate entity and enable creditors to pursue claims against the shareholders directly if the shareholders have not treated the corporation as a separate entity and have used the corporation to perpetrate a fraud or some other injustice, such as inadequately capitalizing the corporation. See generally *Mesler v Bragg Mgmt. Co*. (1985) 39 C3d 290, 216 CR 443; *Baize v Eastridge Cos., LLC* (2006) 142 CA4th 293, 47 CR3d 763. To reduce the risk of alter ego claims, corporations ordinarily follow certain basic procedures, including adequately capitalizing the corporation, obtaining insurance appropriate for its needs, observing corporate formalities (*e.g.*, regular shareholder and director meetings and proper corporate recordkeeping), not commingling corporate and shareholder funds, and making clear to contracting parties that they are dealing with the corporation and not one of its shareholders. See generally Organizing Corporations in California, chap 1A (3d ed Cal CEB 2001).

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§6.6 b. Tax Treatment

A corporation is subject to tax as a separate entity under subchapter C of the Internal Revenue Code, unless the corporation is eligible to make an election under subchapter S. S-corporation status is generally not available, however, unless all shareholders are U.S. citizens, resident aliens, or certain qualifying trusts. Net income of a C corporation is subject to both federal and state tax at corporate tax rates. In addition, if the corporation makes a dividend distribution to its shareholders, the shareholders report the dividends received as income and must pay federal and state income taxes on the dividends. The corporation cannot deduct dividend payments made to shareholders as an expense. A shareholder that is a C corporation may, however, deduct dividends received from another C corporation.

So called "double taxation" may be minimized in certain cases by the payment of salaries to shareholder-employees, by payment of fair market rent or royalties to use assets owned by a shareholder, or by payment of fair market interest on a debt owed to a shareholder. In addition, a corporation that retains most of its income for capital reinvestment in the business may benefit from the corporate tax structure because the marginal rates applicable to corporations may be lower than the marginal rates applicable to individuals.

Parties considering use of the corporate form as a joint venture entity should seek tax counsel to analyze the tax consequences of incorporation in advance of forming the corporation. For an overview of tax considerations, see Organizing Corporations in California §§1.35-1.81 (3d ed Cal CEB 2001).

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§6.7 c. Shareholders; Management and Fiduciary Duties

A corporation may issue one or more classes or series of shares or both, with full, limited, or no voting rights and with other rights, preferences, privileges, and restrictions as stated in the articles of incorporation, bylaws, or elsewhere. At least one class or series of stock must have voting rights and unlimited dividend and liquidation rights. Corp C §400(a). By varying the rights of different classes and series of stock, voting control, distributions, and other aspects can be varied to enhance the returns and powers of one group of investors relative to another.

Governance of a corporation is vested in its board of directors (Corp C §300), who are designated initially by the incorporator unless the initial directors are named in the articles of incorporation. See Corp C §210. Following issuance of shares, the shareholders elect the board of directors at their annual meeting. Corp C §310. The board in turn elects officers to manage the day-to-day affairs of the corporation, including a president, a corporate secretary, a chief financial officer, and other officers as may be stated in the bylaws or determined by the board. Corp C §312.

Corporate directors and officers have two basic fiduciary duties: the duty of loyalty and the duty of care. In California, these duties are reflected in Corp C §309(a). In general, the duty of loyalty prohibits corporate directors and officers from serving their own interests at the expense of the corporation. As a fiduciary of the corporation, each director must act in the best interest of the shareholders of the corporation when making decisions that affect the corporation, subordinating his or her individual financial and professional interests to the interests of the corporation's shareholders. The duty of care requires directors and officers to be competent and diligent and to exercise good faith in their decision-making and supervisory functions. Each officer and director must act with the level of care, including reasonable inquiry, that an ordinarily prudent person in a like position would under similar circumstances. For further discussion of the fiduciary duties of corporate directors and officers, see Counseling California Corporations, chap 2 (3d ed Cal CEB 2008).

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§6.8 d. State of Incorporation

One threshold question is the state in which the corporation should be incorporated. In general, in most cases, it is best to form the corporation in the state where the principal place of business of the corporation will be located. Choosing another state usually results in higher ongoing costs in the form of additional taxes and fees resulting from the need to comply with laws of two jurisdictions.

Moreover, foreign (*i.e.,* non-California) corporations with significant contacts in California must comply with a number of provisions of the California Corporations Code as if they were California corporations.

Unless its stock is publicly traded (see Corp C §2115(c)), a foreign corporation will be subject to certain California corporate laws (to the exclusion of the corresponding laws of its state of incorporation) if more than 50 percent of its voting shares are owned of record by California residents and more than 50 percent of the average of the value of its personal and real property, its payroll, and its sales is derived in California. Corp C §2115(a). But see *VantagePoint Venture Partners 1996 v Examen, Inc.* (Del 2005) 871 A2d 1108 (refusing to apply California law). In general, the applicable California corporate law provisions (including the directors' standard of care, cumulative voting rights, provisions for annual elections of directors, limitations on director and officer indemnification, and anti-takeover provisions) are perceived to be more favorable to shareholders. See Corp C §2115(b). Corporations subject to Corp C §2115(b) are commonly known as "quasi-California corporations" or "pseudo foreign corporations."

Delaware may be selected as the state of incorporation if the new business plans to conduct a public securities offering soon after formation. Alternatively, a corporation planning to go public later can reincorporate in Delaware at that time. Delaware corporate law is generally perceived to be more friendly to management, by offering more protection for directors and officers, more power for majority stockholders, and greater flexibility in dealing with minority stockholders. See generally Marsh, Finkle & Sonsini, Marsh's California Corporation Law, vol 1, §2.05 (4th ed, Aspen Publishers, 2000) (comparison of Delaware and California law). Incorporation in Nevada is sometimes touted as an alternative to incorporation in California. Except for the fact that stock can be issued for future services in Nevada (see Nev Rev Stat §78.211), the perceived benefits of incorporation in Nevada may be largely illusory. See generally Unger & Meadows, *The Myth of Incorporating in Nevada: Sorting Through the Hype*, 17 CEB Cal Bus L Prac 81 (Summer 2002).

For further discussion of the question of the choice of jurisdiction for incorporation, see Organizing Corporations in California §§1.129-1.140 (3d ed Cal CEB 2001).

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.9 2. Limited Liability Companies

§6.9 2. Limited Liability Companies

Often, in the United States, a limited liability company (LLC) is the most desirable entity for a joint venture organized to exploit intellectual property rights. An LLC is a form of business organization with one or more owners (called members), none of whom have individual liability for the debts and obligations of the LLC (see Corp C §17101). In California, LLCs are governed by the Beverly-Killea Limited Liability Company Act (Corp C §§17000-17656). The key advantage of an LLC over a corporation is that an LLC has substantially similar tax attributes as a partnership, with no federal or state income tax due at the entity level. In addition, apart from annual state filings and payment of fees, there are few post-formation formalities mandated by statute. As in a partnership, LLC members have freedom to structure management rights and financial interests in the entity in almost any configuration that the parties wish. LLCs are attractive because of their organizational and structural flexibility and the ability of members to engage actively in management without risk of liability. Further, by varying the rights of different classes of membership interests, voting control, distributions, and other attributes of LLC membership can be varied to enhance the returns and powers of one group of members in relation to another. Corp C §17102.

Certain important features of limited liability companies are noted in §§6.10-6.12. For comprehensive discussion of LLCs, see Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

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§6.10 a. Limited Liability

Like corporate shareholders, members of an LLC are not ordinarily liable for the debts and obligations of the LLC, unless they guarantee LLC debts, engage in tortious conduct, receive improper distributions, become subject to "alter ego" claims, breach duties to other members or the LLC, or otherwise agree to be liable. The failure of LLC members to hold, or to observe formalities related to, meetings will not ordinarily create individual liability for the members. Further, members may participate in the management of the LLC without ordinarily creating individual liability for themselves as members. See generally Corp C §§17101, 17150; Forming and Operating California Limited Liability Companies, chap 13 (2d ed Cal CEB 2007).

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§6.11 b. Tax Treatment

Like a partnership, an LLC is generally not subject to federal or state income tax at the entity level (unless it elects to be taxed as a corporation under the federal and state "check the box" regulations; see Treas Reg §§301.7701-1—301.7701-3; Rev & T C §23028). In California, however, an LLC must pay an annual franchise tax of $800 to the state (see Rev & T C §17941) plus an annual statutory fee of from $900 to $11,790, depending on the amount of the LLC's gross income derived from or attributable to California (see Rev & T C §17942(a)). Members of an LLC receive the same pass-through tax treatment as partners of a partnership and may agree to special allocations of profits and losses. For further discussion of tax issues concerning LLCs, see Forming and Operating California Limited Liability Companies, chaps 4-5 (2d ed Cal CEB 2007).

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§6.12 c. Management and Fiduciary Duties

A limited liability company may be managed by its members or by one or more designated managers, who may, but need not, be members. Corp C §§17150-17151. The law allows members considerably flexibility in determining the LLC's management structure.

The LLC's operating agreement normally contains detailed provisions for management of the LLC, including the appointment of officers (such as president, secretary, chief financial officer, or other officers) if desired by the members. See Corp C §17154. In general, an LLC operating agreement should contain many of the same provisions typically included in partnership or shareholder agreements; the LLC law provides default provisions that will control if the parties' operating agreement is silent on a given matter. See Corp C §17005. If exploitation of intellectual property rights is an important purpose of the new entity, the rights of the parties in ownership, development, and use of the LLC's intellectual property should be detailed in the operating agreement.

LLC managers owe the same fiduciary duties to the LLC and to its members as partners owe to a partnership and the other partners. Corp C §17153. See generally Forming and Operating California Limited Liability Companies, chap 6 (2d ed Cal CEB 2007).

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3. Partnerships

§6.13 a. General Partnerships

A partnership is an association of two or more persons to carry on as co-owners a business for profit; the "persons" may be corporations, limited liability companies, other partnerships, or individuals. See Corp C §16101(7), (9), (13). General partnerships formed under California law are governed by the Uniform Partnership Act of 1994 (Corp C §§16100-16962). A general partnership is considered a separate legal entity distinct from its partners. Corp C §16201. Thus, partnership property is owned by the partnership itself, not by the partners. Corp C §16501. A change in partnership membership alone does not terminate the partnership. Corp C §§16701, 16801.

General partnerships have the following characteristics: Each partner is an agent of the partnership and can bind the partnership in its ordinary course of business. Corp C §16301(1). Each partner is individually liable for the obligations of the partnership. Corp C §16306. The partnership may be dissolved by the express will of at least half of the partners, even in contravention of a written agreement to the contrary. Corp C §16801(1). Each partner owes the partnership and the other partners fiduciary duties of loyalty and of care. The scope of these duties is detailed in the partnership statute. See Corp C §16404.

For businesses in which the potential for individual liability is not a major concern (or can be insured against), a general partnership may be an attractive alternative to incorporation. The partnership agreement normally details governance and management relationships. General partnerships have a distinct disadvantage over corporations as a form of legal entity, namely, their decentralized management structure. Unless the partnership agreement constructs a management hierarchy, all partners have equal management power and authority. See Corp C §16301. The partnership agreement will typically also address, *e.g.,* division of profits and losses of the enterprise, the ability of a partner to engage in other business activities, termination of the enterprise, and withdrawal of partners.

Unless it elects to be taxed as a corporation under the federal and state "check the box" regulations (see Treas Reg §§301.7701-1—301.7701-3; Rev & T C §23028), a general partnership is entitled to pass-through tax treatment and will not be subject to federal or state income tax at the entity level.

A joint venture is identical to a general partnership in many respects, but it is formed for a limited or temporary business purpose and is often not intended to have an unlimited continuity of existence. Joint ventures have generally been treated as general partnerships under California law. See §6.74. Limited liability companies, however, are becoming the entity of choice for most limited purpose business ventures.

For comprehensive discussion of general partnerships, see Advising California Partnerships (3d ed Cal CEB 1999).

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§6.14 b. Limited Partnerships

A limited partnership is a partnership with one or more limited partners—*i.e.,* partners designated in the agreement as limited partners who do not participate in the control of the business and who are not personally liable for the obligations of the partnership—and one or more general partners—*i.e.,* partners who actively engage in the management and control of the business and who have unlimited personal liability for the obligations of the partnership. See Corp C §15611(r) (Corp C §15901.02(q) in the latest revision of the California limited partnership law). Like general partnerships, limited partnerships offer pass-through tax treatment, and are not subject to federal or state income tax at the partnership level. In the author's experience, the limited partnership form is practically never used for joint ventures organized to exploit intellectual property. For comprehensive discussion of limited partnerships, see Advising California Partnerships (3d ed Cal CEB 1999).

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§6.15 B. Securities Law Issues

All offers and sales of securities, including stock of corporations and membership interests of LLCs, must comply with federal and state securities laws, including requirements that the offering be registered with the SEC and qualified with the California Department of Corporations (DOC), unless either the transaction or the security itself is exempt from qualification. Often, the issuance of equity to the founders of a corporation or LLC formed for joint development of intellectual property qualifies for exemption as a private or limited offering if the founders qualify as "accredited investors" (see 17 CFR §230.501(a)) and are each active in management of the new business, although notice filings with the SEC and DOC may be required. If the corporation or LLC will include passive investors, additional analysis must be performed to determine the availability of an exemption. Equity interests in general partnerships are not generally considered to be securities, because the partners are active in management of the business and have general liability for its debts and obligations. See *Matek v Murat* (9th Cir 1988) 862 F2d 720.

Counsel should evaluate the potential application of both federal and state securities laws with respect to any offer, issuance, sale, or transfer, or any changes in the rights, preferences, or privileges, of any equity interest in a new legal entity. Further discussion of securities issues is beyond the scope of this chapter. For detailed information on qualifying for exemption as a private placement under federal and state laws, see Financing and Protecting California Businesses, chap 6 (Cal CEB 2006); Forming and Operating California Limited Liability Companies, chap 12 (2d ed Cal CEB 2007).

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§6.16 C. Contributing Intellectual Property Rights

In forming a new business venture for the exploitation of intellectual property rights, the parties often contribute a mix of capital, intellectual property rights, equipment, facilities, and agreements for services, in exchange for equity interests in the new venture. The types of intellectual property that may be contributed may include patents, patent applications, nonpatented inventions, trade secrets, know-how, confidential information, software, registered copyrights, unregistered works of authorship, registered trademarks, trademark applications, unregistered trademarks, and other United States and foreign intellectual property rights. The fair market value of any noncash assets contributed must be determined and agreed to by the parties, so that the parties' relative ownership interests in the new entity can be determined. For discussion of intellectual property valuation, see chap 2. Some of the issues involved in contribution of intellectual property rights to a new business entity are discussed in §§6.17-6.36.

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§6.17 1. Manner of Contribution

Intellectual property rights may be contributed to a new business venture either by an outright assignment or by a license of intellectual property rights to the new entity. Regardless of the manner of contribution, the rights are generally contributed in exchange for equity ownership in the new entity, a participation in profits, a share of any new intellectual property created by the enterprise, or a combination of these, or other, elements. Intellectual property rights may also be contributed to the new business venture in exchange for cash consideration.

NOTE: If the parties' business relationship does not involve formation of a new legal entity, the parties typically license or cross-license intellectual property rights to one another. See §6.67.

Assignments of intellectual property rights, including sample forms of assignment, are discussed in §§8.4-8.20. Intellectual property licenses are discussed in chap 5. A sample form of patent license is presented in App A; a sample form of trademark license is presented in App B.

Valuation of each party's contribution of intellectual property rights will depend not only on the underlying value of the rights themselves, but also on the manner of their contribution, whether as an outright assignment or a license. If the intellectual property will be licensed to the new venture, the value of the contribution will also depend on whether the license is exclusive or nonexclusive, the term of the license, and other features of the license agreement. Valuation of intellectual property is discussed in chap 2.

In addition to contributions of existing intellectual property, the parties' agreement should also address ownership rights to the intellectual property created by the new venture. The newly created intellectual property may include improvements and derivative works based on the parties' contributions of existing intellectual property, as well as independent creations. The parties may provide that newly created intellectual property will be owned by the entity or by one of the parties (for an example of the latter, see §6.49).

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§6.18 2. Patents

United States patents arise solely under federal law. A patent is a grant, issued by the United States Patent and Trademark Office (PTO), of an exclusive right under the Patent Act of 1952 (35 USC §§1-376) to make, use, or sell an invention for a specified period of time, usually 20 years. See 35 USC §154(a). A patent can be obtained for a device or process that is novel, useful, and nonobvious. Patentable subject matter includes any apparatus, machine, composition of matter, method (including business processes), or improvements to the foregoing. See 35 USC §§101, 103. An issued patent does not directly grant a right to use a patented invention or process, but rather the right to exclude others from using or selling that invention or process. See 35 USC §154(a)(1).

If patent rights will be important strategically to the new venture with respect to its competitors, the new venture's patents and patent applications should be reviewed carefully by the parties' patent attorneys to evaluate their strength. For discussion of patent due diligence, see chap 4. Although an issued patent is presumed to be valid, patents may be found invalid if challenged, and defending a suit challenging the validity of a patent can be very expensive.

NOTE: For a more extensive discussion of patent law, see California Business Litigation, chap 8 (Cal CEB 2002). See generally Chisum, Chisum on Patents: A Treatise on the Law of Patentability, Validity and Infringement (2007).

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§6.19 a. Patent Assignments

Assignments of patents are discussed in §8.5. A sample form of patent assignment is presented in §8.6. Patent assignments must be recorded in the PTO to afford constructive notice to any subsequent third party assignees. See generally 35 USC §261; 37 CFR §§3.1-3.41. The PTO form for recordation of the assignment is reproduced in §8.7.

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§6.20 b. Patent Ownership Issues

Patent applications are required to be made by the inventor or his or her assignee (see 35 USC §§111, 118), and patents are issued to the applicant (see 35 USC §151). Accordingly, if an assignment from the inventor to the new business entity is not obtained and duly recorded in the PTO, the inventor is presumed to be the true owner of the patent. To avoid ownership issues, the new venture should ensure that all of its employees and independent contractors execute invention assignment agreements. For further discussion of this issue, see §§6.39-6.40. See also §§8.15-8.17.

Inventions developed with state or federal funding or university research funding may be subject to governmental or university rights. If the new venture wishes to exploit intellectual property rights developed with government or university funding, the scope of the government's or university's rights must be ascertained and appropriate licenses obtained. See §§8.26 and 8.28 for further discussion of issues pertaining to university and government rights. A sample form of patent license from a university is presented in §8.27.

Potential joint ownership of patent rights is another issue that may complicate the transfer of intellectual property rights to a new business venture. One of the parties intending to contribute patent rights may own the patent jointly with another party or may wish to retain joint ownership of a patent along with the new entity. Whatever the circumstances, if the new entity is a joint owner of a patent, each joint owner has an equal, undivided interest in the patent and will be free to exploit the patent independently of the other. See 35 USC §262. Joint ownership will also affect the valuation of the patent rights contributed to the new venture.

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§6.21 3. Trademarks

In the United States, trademarks are subject to both federal and state law. The applicable federal law is the Trademark Act of 1946 (also known as the Lanham Act), 15 USC §§1051-1129; the federal agency responsible for administering the Lanham Act, including federal trademark registration, is the U.S. Patent and Trademark Office (PTO). If a trademark will be used in only one state, the trademark may be registered at the state level only as an alternative to federal filing. California law governing trademarks and service marks is in Bus & P C §§14200-14272, and the Secretary of State's office maintains registration records and updates of trademarks and service marks registered in California. A trademark need not be registered in order to be valid, but registration brings certain procedural and other advantages, which may be substantial, and significantly enhances the owner's ability to protect its mark.

Under 15 USC §1127, a trademark is defined as "any word, name, symbol, or device, or any combination thereof… used… to identify and distinguish… goods,… from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown." If used to identify and distinguish a service, a mark is referred to as a service mark. Trademarks and service marks are generally treated alike under the Lanham Act. See 15 USC §1053.

Trademark protection is territorial; a trademark registered in the United States does not protect the rights of the registrant in a foreign jurisdiction. United States trademark owners, however, can use the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (June 27, 1989) (see 15 USC §§1141-1141n), referred to as the "Madrid Protocol," to obtain trademark protection in the 74 countries that have adopted it to date by filing only one trademark application with the USPTO. For further information, see http://www.uspto.gov/web/trademarks/madrid/madridindex.htm; http://www.wipo.int/madrid/en.

NOTE: For additional discussion of trademark law, see Internet Law and Practice in California, chap 3 (Cal CEB 2004); California Business Litigation, chap 6 (Cal CEB 2002). See generally McCarthy, McCarthy on Trademarks and Unfair Competition (4th ed West 1992).

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§6.22 a. Preservation of Trademark Rights

In the United States, trademark rights are based on priority of use. See *Sengoku Works Ltd. v RMC Int'l, Ltd.* (9th Cir 1996) 96 F3d 1217, 1219, cert denied (1997) 521 US 1103 ("the party claiming ownership must have been the first to actually use the mark in the sale of goods or services"). Moreover, a trademark will be deemed to be abandoned if its use in trade has been discontinued. See 15 USC §1127. As a consequence, businesses must take steps to preserve their trademark rights by protecting the value, significance, and distinctiveness of their marks. Formal policies should be adopted, prescribing allowable uses of company marks by employees, licensees, and others with access to them. For sample trademark policy guidelines, see Internet Law and Practice in California §3.55 (Cal CEB 2004). For sample trademark license quality-control provisions, see §5.66. See also the sample form of trademark license in App B.

Sometimes, companies with international operations establish offshore intellectual property holding companies in order to manage their intellectual property assets, as well as to reduce their tax burden. Offshore holding companies may offer substantial tax advantages, but certain formalities must be observed. For example, with respect to trademarks, if the offshore holding company is the trademark owner, it has responsibility for exercising quality control over use of the trademarks by its licensees and subsidiaries. Failure to do so could result in the loss of valuable trademark rights.

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§6.23 b. Trademark Assignments

Trademarks may not be effectively transferred or licensed without the goodwill associated with the trademark. See 15 USC §1060. Assignments of trademarks are discussed in §8.8. A sample form of trademark and goodwill assignment is presented in §8.9. Like patent assignments, assignments of federally registered trademarks must be recorded in the PTO to afford constructive notice to any subsequent third party assignees. See generally 15 USC §1060(a)(4); 37 CFR §§3.1-3.41. The PTO form for recordation of the assignment is reproduced in §8.10.

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§6.24 4. Copyrights

In the United States, copyrights created on or after January 1, 1978, are governed by the Copyright Revision Act of 1976 (the Copyright Act), 17 USC §§101-1332. Internationally, the Berne Convention for the Protection of Literary and Artistic Works, available at http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html, has been adopted by 163 nations to date, including the United States. Under the Copyright Act, copyright protection extends to any original work of authorship fixed in a tangible medium of expression, but does not extend to ideas or concepts. 17 USC §102. Subject to certain statutory limitations, including the doctrine of fair use (see 17 USC §107), a copyright owner has the following exclusive rights: (1) the right to reproduce the work; (2) the right to prepare derivative works based on the work; (3) the right to distribute copies of the work; (4) the right to perform the work publicly; and (5) the right to publicly display the work. See 17 USC §106.

NOTE: For further discussion of copyrights, see Internet Law and Practice in California, chap 1 (Cal CEB 2004); California Business Litigation, chap 7 (Cal CEB 2002). See generally Nimmer & Nimmer, Nimmer on Copyright (LexisNexis 1963).

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§6.25 a. Copyright Assignments

Assignments of copyrights are discussed in §8.11. A sample form of copyright assignment is presented in §8.12; a form of assignment tailored for software is presented in §8.13. Like patent and trademark assignments, assignments of federally registered copyrights must be recorded in the U.S. Copyright Office to afford constructive notice to any subsequent third party assignees. See generally 17 USC §205(a). The U.S. Copyright Office form for recordation of the assignment is reproduced in §8.14. For further information on procedures for transferring copyrights, see U.S. Copyright Office Circular 12, available at http://www.copyright.gov/circs/circ12.pdf.

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§6.26 b. Works Made for Hire

Ordinarily, copyright ownership vests in the author of the work. 17 USC §201(a). One exception to this rule, however, concerns "works made for hire." 17 USC §201(b). In general, a "work made for hire" is either (1) a work prepared by an employee within the scope of his or her employment, or (2) a work specially ordered or commissioned as a contribution to a collective work, as a part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer material for a test, or as an atlas, if the parties agree in writing that the work is one made for hire. See 17 USC §101. If the work has been created by an employee, it is normally considered a work made for hire, and the copyright vests automatically in the employer. It is nonetheless advisable for employers to obtain acknowledgements from their employees of the work-for-hire status of their work product, including a confirmatory assignment of the copyright. For further discussion, see §6.39. For a sample form of employee agreement that includes such an acknowledgment and assignment, see §8.16. See also Advising California Employers and Employees §§2.56-2.58 (Cal CEB 2005).

If a work has been created by an independent contractor, however, it normally would *not* be considered a work made for hire in the absence of a written agreement to that effect between the contractor and the employer. The parties to a new business venture should be particularly cautious in dealing with copyrighted works, such as custom software, developed by independent contractors who will, in the absence of an agreement, own the copyright. The parties should ensure that each independent contractor has executed a written agreement, such as the sample form in §8.17, containing an assignment of the copyrights in their work product to the appropriate entity. See also §6.40.

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5. Trade Secrets

§6.27 a. Generally

In the United States, trade secret protection is largely a matter of state law. Under California law, trade secrets include any information, such as a formula, pattern, compilation, program, device, method, technique, or process, that (1) is not generally known in the industry, to the public, or to others who can realize economic value from its disclosure or use; (2) derives independent economic value, actual or potential, from its secrecy; and (3) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. CC §3426.1(d). A broad range of information may be eligible for protection as trade secrets, including customer and supplier lists, manufacturing methods, know-how, negative information (*i.e.,* what does not work), marketing and financing plans, new product ideas, and computer software source code and related information. See generally Trade Secrets Practice in California, chap 1 (2d ed Cal CEB 1996).

Both state and federal law make misappropriation of trade secrets a crime under certain circumstances. See, *e.g.,* 18 USC §§1831-1839 (Economic Espionage Act of 1996); 18 USC §§2311-2322 (National Stolen Property Act); Pen C §499c (theft of trade secret). See generally Trade Secrets Prac, chap 13.

NOTE: For further discussion of trade secrets, see Trade Secrets Prac; Advising California Employers and Employees, chap 11 (Cal CEB 2005); California Business Litigation, chap 4 (Cal CEB 2002). See generally Milgrim, Milgrim on Trade Secrets (LexisNexis 2007).

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§6.28 b. Trade Secret Protection Plans

To ensure legal protection, a company should undertake reasonable efforts to maintain the confidentiality of its trade secrets. Reasonable efforts may include advising employees and consultants of the existence of trade secrets, obtaining nondisclosure agreements from employees and consultants, limiting access on a "need to know" basis, and controlling access to the physical plant where the information is available. Companies should also guard against inadvertent disclosure, for example, by shredding discarded documents and encrypting confidential information transmitted electronically. Trade secret protection will be lost once the information becomes generally known. See CC §3426.1. A trade secret does not, however, lose protection merely because it is known by more than one party, provided that the information is not generally known to the public and each trade secret holder makes reasonable efforts to maintain its secrecy.

Developing and implementing a trade secret protection plan is a crucial part of a company's efforts to preserve its trade secrets. The trade secret protection plan should encompass written policies available to all employees and consultants and should be discussed with all parties who may have access to the company's trade secrets. The trade secret protection plan must be broad enough to provide protection, yet not be so demanding that employees and consultants are unable or unwilling to comply.

Confidentiality agreements (also referred to as proprietary information agreements) between the company and each employee or consultant who might have access to trade secrets are the key element of any trade secret protection plan. Confidentiality agreements are common in technology-based businesses and may be of critical importance in emerging technology businesses where technology evolves faster than patent protection can be obtained. Confidentiality agreements are discussed further in §6.38.

Other key elements of an effective trade secret protection plan are discussed briefly in §§6.29-6.34. For more detailed discussion of trade secret protection strategies, see Trade Secrets Practice in California, chap 4 (2d ed Cal CEB 1996); Advising California Employers and Employees, chap 11 (Cal CEB 2005).

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§6.29 (1) Identification of Trade Secrets

The first step in creating an effective trade secret protection plan is for the company to identify all possible trade secrets. In this process, both independent contractors and employees should be consulted. The plan should set forth specific categories of information (*e.g.,* specific marketing plans and manufacturing processes) as well as a general catch-all category, *e.g.,* "all other information not publicly known and of potential value to competitors." Identification is crucial, not only for proper management of a company's intellectual property, but also for defending claims of trade secret misappropriation. California law requires trade secret plaintiffs to identify alleged trade secrets with reasonable particularity before discovery can begin. See CCP §2019.210. Proper identification of its trade secrets will enable the company to better evaluate the plaintiff's claims and to prepare defenses such as nonsecrecy and independent derivation.

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§6.30 (2) New Hires

In technology-intensive industries, employees often work serially for multiple employers within a relatively narrow field. When hiring employees who once worked for a competitor or otherwise had access to a competitor's trade secrets, it is essential for a company to inform the individual that he or she must not disclose or use any of the competitor's trade secrets. If possible, the company should obtain a copy of any nondisclosure agreement between the new employee and his or her former employer. As part of the new employee's employment agreement, the company should ask the individual to acknowledge that he or she has been informed of his or her duty not to disclose the trade secrets of any former employers and that he or she has not brought to the new job any confidential documents, electronically stored data, or other information from any former employer. For an example of such a provision, see section 1.3 of the Employee Confidentiality and Proprietary Rights Agreement in §8.16.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.31 (3) Employee Education

§6.31 (3) Employee Education

Perhaps the most effective method of preventing inadvertent disclosure of trade secrets is an ongoing program of employee education. Employees should be made aware of the importance of protecting the company's trade secrets and the ways in which trade secrets can be disclosed inadvertently. To avoid inadvertent disclosure of trade secrets, employees should be well versed in the identification, classification, labeling, and handling of confidential materials. Even if materials are improvidently released, the employer has a stronger position in litigation if the release was a breach of fully implemented security policies. See *Courtesy Temporary Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352.

The company should implement an employee awareness program that periodically reminds employees, either in writing or in presentations by management, that the company's trade secrets are valuable company assets and that measures must be taken to protect those secrets. Employees should be reminded of specific acts that may constitute misappropriation of the company's trade secrets, such as accessing a password-protected computer database to obtain customer lists and solicit customers. See *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289. In addition to implementing nondisclosure agreements for employees, such programs, when feasible, may include:

- Notices and posters reminding employees that their work involves access to the trade secrets of the company and listing ways to ensure the protection of trade secret information;
- Periodic communications emphasizing the importance of maintaining confidentiality of company documents and reminding employees of their confidentiality obligations;
- Color-coding documents to remind and inform employees of their confidential nature;
- Presentations describing the company's protection plan and a written description of the plan for inclusion in an employment manual; and
- Requiring the employees to read the employee manual and sign an agreement to be bound by its terms. The manual may state, for example, that the employee agrees not to disclose or use for his or her own benefit any confidential information and trade secrets of the company.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.32 (4) General Preventative Measures

§6.32 (4) General Preventative Measures

The trade secret protection plan should provide for a number of elements designed to prevent the inadvertent disclosure of trade secrets, such as the following:

- Procedures for reviewing any public speeches or publications by employees, and guidance for employees to protect against inadvertent disclosure of trade secrets at trade shows and in conversations with competitors or customers;
- A company-wide system for marking documents that contain secrets as "Confidential";
- Limitations on dissemination of confidential material within the company, including password protection for electronic files;
- Security measures relating to the company's physical premises, such as locked doors, locked file cabinets, and restricted visitor access;
- Policies limiting removal of confidential information from the company's premises, including protections for both electronic and paper files; and
- Secure disposal or recycling of confidential materials.

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§6.33 (5) Exit Interviews

Employees who have been exposed to trade secrets present a high risk of possible future misappropriation of the trade secrets on departure from the company. Most employees do not intend to misappropriate their former employers' trade secrets, but they need reminders, instruction, or both to help them understand and meet their legal obligations in this regard. Thorough employee exit interviews should therefore be conducted, and the company should develop a standard checklist for exit interviews.

The exit interview should be conducted by a trained supervisor who should explain to the departing employee that he or she was exposed to and has knowledge of the company's trade secrets; has a continuing legal obligation under the nondisclosure agreement previously signed to hold the information in confidence and not use it in any new employment; and is free to use general skills and know-how acquired while employed with the company but may not use the company's trade secrets.

The interviewer should review with the employee the various areas or classes of the company's trade secrets. The interviewer can inventory the trade secrets in the departing employee's possession, including a list of the documents, notebooks, files, and other tangible items containing trade secret information that should be recovered before the employee leaves. The employee should be questioned to ensure, and should confirm in writing, that no proprietary information is stored on personal computers or computer disks in the possession or under the control of the employee. The company should verify that the employee no longer has access to on- or off-site computer systems. The interviewer should also ask the employee what his or her new job duties entail to help evaluate whether the new job will require the employee inevitably to disclose trade secrets. The company should consider sending a letter to the new employer to make it aware of the employee's exposure to trade secrets and its potential liability for using any such information if disclosed.

For further discussion of, and a checklist for, exit interviews, see Trade Secrets Practice in California §§4.13, 6.40-6.41 (2d ed Cal CEB 1996).

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§6.34 (6) Controlling Access by Third Parties

A comprehensive trade secret protection plan should address dealings with third parties. Unlike company employees, outsiders have no inherent legal duty to refrain from using or disclosing a company's trade secrets (unless they have obtained the information through improper means). Accordingly, independent contractors, consultants, potential investors, and other third parties with access to a company's trade secrets should be required to sign confidentiality agreements. For a sample of a confidentiality agreement between two companies contemplating an acquisition transaction, see §8.3. For a sample of a nondisclosure agreement between a company and an independent contractor, see Internet Law and Practice in California §4.21 (Cal CEB 2004). See also the sample independent contractor agreement in §7.17.

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6. Intellectual Property Infringement Issues

§6.35 a. Risk of Successor Liability

Whether intellectual property rights are acquired by the new business venture from one or more of the parties themselves or from a third party, the new venture risks exposure to successor liability if the transferred rights infringe or misappropriate the intellectual property rights of others. This risk also exists in licensing transactions or collaborations where no new legal entity is formed, and is typically addressed by the parties in indemnification agreements. For further discussion of intellectual property infringement indemnification, see §6.73. For discussion of insurance issues in connection with intellectual property infringement, see §6.36.

For a general discussion of the status of the doctrine of successor liability in California, see Kuney & Looper, *Successor Liability in California*, 20 CEB Cal Bus L Prac 50 (Spring 2005).

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§6.36 b. Insurance Against Infringement Claims

The broad coverage available to insureds under newer commercial general liability (CGL) insurance policies may or may not extend to intellectual property infringement claims, especially claims relating to trademark, trade dress, and copyright infringement, depending on the policy terms and exclusions. California courts construing CGL insurance policies have ruled that coverage does not extend to patent infringement claims absent specific additional coverage obtained at extra cost. When available under CGL policies, coverage for intellectual property infringement claims typically falls within the "advertising injury" portion of the policy. To establish coverage under the advertising injury provisions, the insured must show that the claim arising from alleged copyright or trademark infringement or trade secret misappropriation relates to the insured's advertising activities. See *Delta Computer Corp. v Walter J. Frank* (5th Cir 1999) 196 F3d 589.

Some courts have held that there is no advertising injury coverage for misappropriation of trade secrets because the act of misappropriation occurs before any promotion or advertising activity related to the trade secret. *Winklevoss Consultants, Inc. v Federal Ins. Co.* (ND Ill 1998) 991 F Supp 1024. Other courts, however, have found that a claim for trademark infringement "easily qualifies as an 'advertising idea' " justifying coverage and a duty to defend. See, *e.g., Central Mut. Ins. Co. v StunFence, Inc.* (ED Ill 2003) 292 F Supp 2d 1072, 1079.

Courts have held that a party can be liable for patent infringement that is not committed in the course of advertising activities, and if so, there is no insurance coverage for such claims under advertising injury provisions. *Gencor Indus., Inc. v Wausau Underwriters Ins. Co.* (MD Fla 1994) 857 F Supp 1560; *Aetna Cas. & Sur. Co. v Superior Court* (1993) 19 CA4th 320, 23 CR2d 442. One court held that there was no insurance coverage for patent infringement notwithstanding that the plaintiff relied on the infringing party's use of press releases, brochures, and catalogs to advertise the infringing product. *FileNet Corp. v Chubb Corp.* (NJ App 1999) 735 A2d 1170.

As a result, an unwary insured may find that its CGL coverage provides only limited coverage for certain liabilities arising out of intellectual property rights. Companies at risk for patent or trade secret infringement claims or other intellectual property claims should be aware of and understand the scope and potential limits of the insurance coverage that they purchased.

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D. Human Resources Issues

§6.37 1. Generally

Engaging the right people to staff a new business venture is often crucial to its success. Moreover, once an employee is hired, clear and thorough employment documentation will help both the company and the employee avoid confusion and potential disputes over the terms of employment and intellectual property allocation and ownership issues. Because employees are often the primary source of the creation of new value for a company (by developing client relationships, creating intellectual property, and keeping historical knowledge about the company and its operations), proper documentation will aid in securing for the company's benefit the value that the employees create during the course of their employment.

Selection of employees for a new venture, their duties, and the procedures for their termination are all issues that may be addressed in the parties' joint venture agreement. If certain key employees, such as management representatives of the parties to the joint venture, are necessary for its operations, they may be identified in the agreement and their authority and duties, the terms of their engagement, and procedures for termination and replacement may be detailed in the agreement.

For comprehensive discussion of labor and employment issues, including basic forms of employment contracts, see Advising California Employers and Employees (Cal CEB 2005).

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§6.38 2. Confidentiality Agreements

Confidential information may be one of a new venture's most valuable business assets, yet the success of the venture inevitably depends on sharing that information to a greater or lesser extent with employees as well as third parties such as independent contractors, vendors, suppliers, licensors, or licensees. In additional to the trade secrets of the business (see §§6.27-6.34), valuable confidential information may include material (such as business and financial plans; customer, vendor, and suppliers lists; and contracts) that, for one reason or another, is not legally entitled to trade secret protection.

To maintain the confidentiality of such information, it is essential for the company to enter into confidentiality agreements with all employees who may have access to it. The agreements should define what information is confidential, and set forth the parties' obligations to preserve its confidentiality. The agreements should also address the limitations on the parties' use of the confidential information, *e.g.,* for the purposes of the new business.

Whether the agreement is separate or made a part of a larger employment contract or invention assignment agreement (see §§6.39-6.40), the company should require employees at all levels to sign agreements promising that they will not use or disclose the company's confidential information without authorization and will exercise care to prevent the unauthorized use or disclosure of confidential information. If an employee did not sign such an agreement when hired, the company should offer some consideration beyond continued employment or engagement as an independent contractor in exchange for entering into the agreement later on.

For a sample form of confidentiality agreement, see the Employee Confidentiality and Proprietary Rights Agreement in §8.16; see also the discussion accompanying the form in §8.15. For further discussion and another form of employee confidentiality agreement, with commentary, see Internet Law and Practice in California, chap 4 (Cal CEB 2004).

NOTE: Noncompetition agreements (covenants not to compete) attempt to prevent a contracting employee from working for a competitor for a designated period of time or within a designated geographical area or industry. Except in a few situations specified by statute, however, noncompetition agreements are unenforceable in California. See Bus & P C §16600. For further discussion of covenants not to compete, see California Law of Contracts §6.38 (Cal CEB 2007); California Business Litigation, chap 3 (Cal CEB 2002).

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3. Invention Assignment Agreements

§6.39 a. Employees

The issue of ownership of inventions and improvements to company technology is vitally important to businesses that rely on intellectual property as the basis of their intrinsic corporate value as well as the value of their products sold in the marketplace. Accordingly, technology companies commonly require their employees to execute invention assignment agreements as a condition of their employment.

Invention assignment agreements have certain statutory limitations in California. Labor Code §2860 provides generally that everything that an employee acquires by virtue of his or her employment (except compensation due) belongs to his or her *employer*. Labor Code §2870(a), however, provides that the *employee* owns any invention that he or she developed entirely on his or her own time, without using any of the employer's equipment, supplies, facilities, or trade secret information—unless the invention resulted from work performed by the employee for his or her employer or is related to the employer's business or its actual or demonstrably anticipated research or development.

Employment agreement provisions purporting to require an employee to assign an invention that is excluded by Lab C §2870(a) are unenforceable. Lab C §2870(b). Moreover, under Lab C §2872, an employer seeking an invention assignment from an employee must give the employee written notice that the agreement does not apply to inventions that qualify under Lab C §2870(a). It is customary to include the statutory notice either in the body of, or as an appendix to, the employee invention assignment. See, *e.g.,* section 2.7 of the form of agreement in §8.16.

For a sample form of employee invention assignment, see the Employee Confidentiality and Proprietary Rights Agreement in §8.16; see also the discussion accompanying the form in §8.15. For further discussion and another form of employee invention assignment agreement, with commentary, see Internet Law and Practice in California, chap 4 (Cal CEB 2004).

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§6.40 b. Independent Contractors

Individuals who fall within the category of independent contractors rather than employees are not subject to Lab C §2860 and copyrighted works they create do not automatically fall within the federal "work for hire" doctrine (see §6.24); accordingly, in the absence of an agreement with the contracting company, independent contractors will have some rights in inventions developed in the course of their engagement. As a result, a new business venture should ensure that its agreements with independent contractors are in writing and include invention assignments in favor of the company. For a sample form of independent contractor agreement confirming an invention assignment, see §8.17. For further discussion and alternative forms of independent contractor agreements, with commentary, see Internet Law and Practice in California, chap 4 (Cal CEB 2004). For discussion of the tests that determine whether a worker is an independent contractor or an employee, see Advising California Employers and Employees, chap 3 (Cal CEB 2005).

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.41 E. Minimizing Risk of Competition

§6.41 E. Minimizing Risk of Competition

In the formation of any new business venture, the principals should consider the risks of competition from other parties to the venture, as well as from current or departing employees. The venture may also face competition from strategic investors who are themselves competitors in the same industry or who have invested in competing businesses.

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§6.42 1. By Principals of New Business Venture

For joint ventures organized as general partnerships subject to the California Uniform Partnership Act of 1994 (Corp C §§16100-16962), the parties have fiduciary duties to one another codified by statute, including the duty of loyalty. The duty of loyalty encompasses the duty "[t]o refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership." Corp C §16404(b)(3). See generally Corp C §16404. The duty of loyalty cannot be eliminated by agreement, but the parties' agreement may specify certain activities that will not violate the duty of loyalty or may allow one or more partners to ratify specific transactions (after full disclosure of all material facts) that would otherwise violate the duty. Corp C §16103(b)(3). See generally Advising California Partnerships, chap 4 (3d ed Cal CEB 1999).

For joint ventures organized as limited liability companies (LLCs) subject to the Beverly-Killea Limited Liability Company Act (the Act) (Corp C §17000-17656), the fiduciary duty analysis is essentially the same. The fiduciary duties owed by a manager of an LLC are the same as those owed by a partner to the partnership and the other partners. Corp. C §17153. If the LLC is managed by its members (as a technology joint venture organized as an LLC typically would be), each member is subject to all the duties and obligations of managers as set forth in the Act. Corp C §17150. Thus, the members of a member-managed LLC owe the same fiduciary duties to each other and to the LLC that a partner owes to the partnership and the other partners. The fiduciary duties of a manager (or of a member-managed LLC) may be modified only in a written operating agreement with the informed consent of the members. Corp C §17005(d).

To minimize the risk of competition by the parties to the venture, the parties' main agreement should include provisions clarifying the permitted scope of their outside activities. For example, the agreement may confine all of the parties' business activities to the joint venture exclusively, thereby eliminating the possibility of competition by one of the principals. More commonly, the agreement will specify the activities that the parties must conduct within the framework of the joint venture and the activities that the parties remain free to conduct separately. For an example of the latter type of provision, see section 3.7 (in §6.48) of the sample form of joint venture agreement beginning at §6.46. Restrictions on outside activities are normally limited to the period that the joint venture is in existence, although termination of the joint venture may be planned to allow competition to a greater or lesser extent by the parties after a certain time.

The parties' agreement should also include confidentiality provisions (see section 16.3 (in §6.60) of the sample form of joint venture agreement beginning at §6.46; see also §6.83), and restrictions on solicitation of joint venture employees, customers, vendors, and suppliers for a specified period.

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§6.43 2. By Employees

While employed, employees have a duty of undivided loyalty to their employer, which encompasses a duty not to compete with their employer. *Stokes v Dole Nut Co.* (1995) 41 CA4th 285, 48 CR2d 673. See also Lab C §2863. It is nonetheless advisable for employers to ask prospective employees to agree in writing not to engage in activities that would create a conflict of interest, such as simultaneously working for a competitor, inducing other employees to do so, or organizing a competing business while employed by the employer. For examples of clauses precluding or restricting an employee's outside business activities and an affirmative covenant not to compete while employed by the company, see Advising California Employers and Employees §§2.25-2.27 (Cal CEB 2005). As noted in §6.38, noncompete agreements intended to operate after an employee has left the company are generally unenforceable in California. See Bus & P C §16600.

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§6.44 F. Exit Strategies

Exit strategies are a significant consideration in structuring a joint venture, not only because joint ventures are usually limited in time, but also because competition between the parties is an important economic issue. The mechanisms for termination of a joint venture are often structured not only to apportion the economic benefits of the joint venture but also to avoid or limit future competition between the parties after the term of the joint venture's existence has ended. Covenants not to compete made in connection with certain events specified by statute, including the sale of an ownership interest in a business or the dissolution of a partnership or limited liability company, are generally enforceable. See Bus & P C §§16601-16602, 16602.5; California Law of Contracts §6.38 (Cal CEB 2007).

Joint venture participants may have different degrees of commitment to the joint venture and their interests may diverge over time, either because their objectives have been satisfied or their strategies have changed over time. In recognition of this possibility, the parties may include somewhat flexible termination provisions in their joint venture agreement. See, *e.g.,* §§6.58, 6.88. Further, the parties often agree in advance on the terms by which the parties' equity interests may be transferred. The parties may agree on restrictions on transfer, such as rights of first offer or rights of first refusal in favor of the nontransferring party or parties, and on procedures to buy out the interests of one or more parties or for one or more parties to sell their interests to other parties. Buy-sell agreements generally set forth the circumstances that trigger the right to buy or sell as well as a formula or procedure for determining the purchase price. For more comprehensive information on rights of first offer or refusal and buy-sell agreements, including model forms, see Business Buy-Sell Agreements (Cal CEB 1991).

Depending on market conditions at the time, the parties may agree to sell the business of the joint venture, either through a sale of all or substantially all of the venture's assets, a sale of a majority or all of its equity securities, or a merger with another company. See generally Sales and Mergers of California Businesses (Cal CEB 2002). The parties may also decide to make a public offering of the equity securities of the venture in the public securities markets, if conditions are favorable. For further discussion of initial public offerings, see Financing and Protecting California Businesses (Cal CEB 2006).

Finally, the parties may simply agree to continue the business of the joint venture and to retain their ownership interests.

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IV. SAMPLE FORM OF JOINT VENTURE AGREEMENT

§6.45 A. Introduction

As discussed in §§6.1-6.14, the parties to a new business venture may structure their legal relationship in one of several possible ways. Unless the parties take the affirmative steps necessary to incorporate or to form a limited liability company, a California joint venture will be governed by the Uniform Partnership Act of 1994 (Corp C §§16100-16962), and the parties will be general partners. See Corp C §16202; *Weiner v Fleischman* (1991) 54 C3d 476, 482, 286 CR 40. See also §6.74.

Set forth in §§6.46-6.62 is a typical form of joint venture agreement between two parties seeking to collaborate in joint research and commercialization of products that are dependent on access to each other's intellectual property rights. The form includes alternative provisions that depend on whether the parties elect to form the joint venture as a partnership or an LLC.

NOTE: If the parties elect to conduct business as an LLC, the drafter should consider whether additional provisions may be necessary or appropriate to take full advantage of the flexibility offered by the limited liability company statutes (Corp C §§17000-17656) and to afford the members important rights, such as rights of first refusal. For a model long-form operating agreement for a California limited liability company, with commentary, see Forming and Operating California Limited Liability Companies, chap 9 (2d ed Cal CEB 2007).

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/ B. Form: Joint Venture Agreement/§6.46 1. Form: Introductory Clauses, Recitals, Definitions

B. Form: Joint Venture Agreement

§6.46 1. Form: Introductory Clauses, Recitals, Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§6.46-6.62.

▶ To download **Word** version, right click and choose *Save Target As*

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6.46-1 Introductory clauses, recitals, definitions

JOINT VENTURE AGREEMENT

This Joint Venture Agreement (this "Agreement") is entered effective as of _ _[*date*]_ _ (the "Effective Date"), by and between _ _[*name*]_ _ ("Company A"), a corporation duly organized and validly existing under the laws of _ _[*name of state*]_ _, with its office at _ _[*address*]_ _, and _ _[*name*]_ _ ("Company B"), a corporation duly organized and validly existing under the laws of _ _[*name of state*]_ _, with its principal office at _ _[*address*]_ _ (each a "Party", and collectively, the "Parties").

RECITALS

A. The Parties wish to establish a joint venture for the purpose of _ _[*describe purpose of joint venture*]_ _ (the "Joint Venture").

B. The Parties wish to enter into an agreement to carry out the purpose of the Joint Venture and to define the respective rights and obligations of the Parties with respect to the Joint Venture.

AGREEMENT

NOW THEREFORE, in consideration of the premises and of the representations, warranties, covenants, and agreements set forth in this Agreement, the Parties agree as follows:

ARTICLE 1: DEFINITIONS

Section 1.1. *Certain Definitions*. As used herein, the following capitalized terms shall have the following meanings:

"Act" means _ _[*the California Uniform Partnership Act of 1994/the California Beverly-Killea Limited Liability Company Act*]_ _, as it may be supplemented or amended from time to time after the date of this Agreement.

"Affiliate" means, with respect to any Person, any other Person that controls, is controlled by, or is under common control with such Person.

[*If joint venture is formed as a limited liability company, add*]

"Articles" means the Articles of Organization of the Joint Venture attached as Attachment A to this Agreement.

[*Continue*]

"Authorized Capital" has the meaning set forth in Section 5.1.

"Board" means the Board of Directors of the Joint Venture.

"Collaboration Discoveries" means any Information that is created, developed, or discovered pursuant to a Party's activities under the Research Program. It is agreed that all Company B Technology and Company A

Technology is excluded from the definition of "Collaboration Discoveries."

"Collaboration Patent" means any Patent or application for a Patent that claims an invention in Collaboration Discoveries.

"Collaboration Product" means any commercial product that comprises or contains, or is developed or manufactured based on or utilizing, or is derived from, the Collaboration Technology or any part thereof.

"Collaboration Technology" means the Collaboration Discoveries and Collaboration Patents, either collectively or any part thereof.

"Company A Technology" means the Company A Improvements, the Company A Know-How, and the Company A Patents, either collectively or any part thereof.

"Company A Territory" means _ _[*describe territory*]**_ _.**

"Company B Technology" means the Company B Know-How, the Company B Improvements, and the Company B Patents, either collectively or any part thereof.

"Company B Territory" means all countries of the world and all territories and possessions thereof, excluding all countries, territories, and possessions within the Company A Territory and the Joint Territory.

"Facilities" means the offices of Company A listed on Attachment B hereto, as the same may from time to time be amended by the Parties in accordance with Section 16.5.

"Force Majeure" means: (a) any order, regulation, or written directive of any Governmental Authority that has jurisdiction over the Joint Venture or the Parties, whether promulgated in the form of law or otherwise; (b) any insurrection, riot, civil disturbance, or war; (c) any strike or other labor disturbance (other than a strike or other disturbance involving the employees of any Joint Venture Participant); (d) any earthquakes, fires, floods, or other acts of God or nature; or (e) any other similar cause or event beyond the reasonable control of the Joint Venture or the affected Party or Parties.

"Formation" means the formation of the Joint Venture as provided in Section 2.1.

"FTE" has the meaning set forth in Section 3.5.

"Governmental Approvals" means all licenses, consents, permits, decrees, orders, authorizations, or other approvals from, all filings and registrations with, and all notices to, any official of any Governmental Authority required for the formation or operation of the Joint Venture or for the execution, delivery, or performance by any of the Joint Venture Participants of any of the Joint Venture Documents.

"Governmental Authority" means _ _[*name of agency*]**_ _, any public, national, regional, local, or municipal governmental body; any department, council, ministry, or other body, agency, instrumentality, or subdivision of any of the foregoing; or any other Person exercising or purporting to exercise executive, legislative, judicial, regulatory, or administrative functions of or pertaining to government.**

"Joint Research Committee" or "JRC" means the committee formed by the Parties to direct and manage the Research Program, as provided in Section 3.2.

"Joint Territory" means _ _[*describe joint territory*]**_ _.**

"Joint Venture" has the meaning set forth in Recital A.

"Joint Venture Documents" means, collectively, this Agreement, the lease referred to in Section 5.3.2, _ _[*list other applicable joint venture documents*]**_ _ and each other agreement or document required (in the determination of either Party) to give effect to the Parties' contributions under Article 5 or its other obligations under this Agreement, as each such agreement or document may be amended, modified, or supplemented, and as in effect from time to time.**

"Joint Venture Main Facility" means the facility located in _ _[*name of location*]_ _, as more fully described in Attachment B to this Agreement.

"Joint Venture Participants" means each Party.

"Know-How" means unpublished research and development information, unpatented inventions, know-how, trade secrets, and technical data.

"Law" means any law, statute, rule, regulation, decree, decision, order, instruction, or other pronouncement having the effect of law issued by any Governmental Authority.

"Net Revenue" means the total revenue received by a Party for sale or other disposition of a Collaboration Product by such Party or an Affiliate or Sublicensee of such Party to a Third Party, less the following to the extent actually incurred or allowed with respect to such sale or disposition: (a) discounts, including cash discounts or rebates, retroactive price reductions, or allowances actually allowed or granted from the billed amount; (b) credits or allowances actually granted on claims, rejections, or returns of Collaboration Products, including recalls, regardless of the Party requesting them; (c) freight, postage, shipping, and insurance charges paid for delivery of Collaboration Product, to the extent billed; and (d) taxes, duties, or other governmental charges levied on or measured by the billing amount when included in billing, as adjusted for rebates and refunds.

"Operating Plan" has the meaning set forth in Section 9.1.

"Ownership Interests" has the meaning set forth in Section 5.5.

"Patent" means (a) a valid and enforceable patent, including any extension, registration, confirmation, reissue, re-examination, or renewal thereof; and (b) to the extent valid and enforceable rights are granted by a governmental authority thereunder, a patent application.

"Person" means any individual, corporation, partnership, association, party, group, joint venture, trust, unincorporated organization, juridical entity, or Governmental Authority.

"Operating Plan" has the meaning set forth in Section 9.1.

"Reasonable Efforts" means efforts and resources commonly used in the research-based pharmaceutical industry for the research, development, and commercialization of a product at a similar stage in its product life, taking into account the establishment of the product in the marketplace, the competitiveness of the marketplace, the proprietary position of the product, the regulatory structure involved, the profitability of the product, and other relevant factors.

"Regulatory Approval" means any approvals, licenses, registrations, or authorizations of any federal, state, or local regulatory agency, or any department, bureau, or other government entity, necessary for the manufacture, use, storage, import, transport, or sale of products in a regulatory jurisdiction.

"Research Plan" means the plan established by the Joint Research Committee setting forth in reasonable detail the goals and activities to be undertaken in the Research Program, performed by the Parties in accordance with Sections 3.1 and 3.5.

"Research Program" means the cooperative research conducted by Company B, in collaboration with Company A, under this Agreement in accordance with the Research Plan.

"Research Term" means the period commencing on the Start Date and ending on the anniversary thereof, as determined and agreed by the JRC as provided in Section 3.2.

"Start Date" means the date, established by mutual agreement of the Parties, on which the Research Program shall commence, as provided in Sections 3.1 and 3.2.

"Sublicensee" means any Third Party expressly licensed by a Party to make and sell one or more Collaboration Products. A Sublicensee shall not include distributors or sales agents that do no more than purchase and resell finished Products on behalf of a Party.

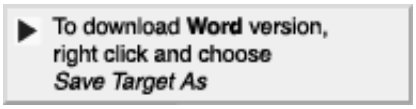
"Third Party" means any entity other than Company B or Company A or an Affiliate of Company B or Company A.

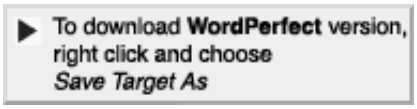
Section 1.2. *Interpretation*. Unless the context otherwise requires, (a) all references herein to "this Agreement" (or words of similar import) shall be deemed to refer collectively to this Agreement (as amended, modified, or supplemented and in effect from time to time) and to the Articles (which are hereby adopted by the Parties) and each other Attachment hereto (all of which form an integral part of this Agreement and are hereby incorporated into this Agreement by reference); (b) all references herein to the word "including" shall be deemed to be followed by the words "but not limited to"; and (c) terms defined in the singular shall have the same meanings when used in the plural and vice versa.

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§6.47 2. Form: Formation of Joint Venture

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6.47-1 Formation of joint venture

ARTICLE 2: FORMATION OF THE JOINT VENTURE

Section 2.1. *Formation.* The Parties hereby agree to form the Joint Venture subject to and in accordance with the provisions of this Agreement and for the purposes described herein. The Joint Venture shall be organized under the Act and shall have all the rights and powers provided for under the Act, all other applicable Laws, and this Agreement. The Joint Venture shall have no liability for the obligations of the Parties or any Governmental Authority (except to the extent otherwise agreed by the Joint Venture), and neither of the Parties shall have any liability for the obligations of the Joint Venture (except to the extent otherwise agreed by such Party).

Section 2.2. *Name and Address*. The name of the Joint Venture shall be _ _[*name*]_ _. The registered office of the Joint Venture shall be at _ _[*address*]_ _.

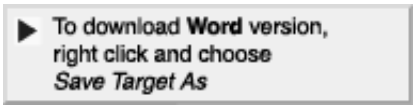
Section 2.3. *Legal Status.* Within _ _[*number*]_ _ days after the date of this Agreement, Company A shall obtain on behalf of the Joint Venture and the Parties any Governmental Approvals necessary for formation of the Joint Venture with _ _[*name of government agency*]_ _ and other Governmental Authorities in accordance with the Act (the "Formation"), and on receipt thereof shall present the Articles, together with all other necessary documents, to _ _[*name of government agency*]_ _ for Formation. Promptly on Formation, Company A shall deliver to Company B certified copies of the Articles as so filed.

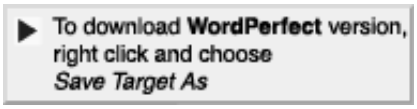
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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.48 3. Form: Collaborative Research

§6.48 3. Form: Collaborative Research

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6.48-1 Collaborative research

ARTICLE 3: COLLABORATIVE RESEARCH

Section 3.1. *Collaborative Research.* Company B and Company A agree that, commencing on the Start Date as established by mutual agreement, they will conduct a research program ("Research Program") on a collaborative basis, with the general goal of developing specific improvements or extensions to certain of the Company B Technology as agreed by the Parties. The specific scope of the Research Program shall be set forth in detail in a research plan established by the Joint Research Committee, as provided in Section 3.5 (the "Research Plan"). The specific work undertaken by the Parties in the Research Program shall be governed by the Research Plan and shall be managed and directed by the Joint Research Committee. The Research Program shall commence on the Start Date and terminate at the expiration of the Research Term, unless the Agreement is earlier terminated as provided in Article 13.

Section 3.2. *Joint Research Committee*. The Research Program shall be managed and directed by the Joint Research Committee ("JRC"), which shall be comprised of 4 individuals, 2 being Company B employees appointed and replaced by Company B at its discretion and 2 being Company A employees appointed and replaced by Company A at its discretion. The size and composition of the JRC may be modified by mutual agreement of the Parties. The Parties shall form the JRC within 20 days after the Effective Date of this Agreement. The JRC shall determine, before the Start Date, the length of the Research Term, which shall not exceed 5 years without written consent of the Parties, and shall be subject to early termination as provided in Article 13. The JRC shall have the following authority and obligations:

3.2.1. To encourage and facilitate the ongoing cooperation and collaboration of the Parties in conducting the Research Program;

3.2.2. To establish, and amend as appropriate, the Research Plan as provided in Section 3.1, which shall govern the specific research tasks and goals of the Research Program;

3.2.3. To establish and implement specific plans for accomplishing the tasks and goals of the Research Plan;

3.2.4. To allocate tasks and coordinate activities of the Parties required to perform the Research Program;

3.2.5. To evaluate the results of the Research Program and discuss information related to the Research Program, and to amend the Research Plan as appropriate;

3.2.6. To ensure that there is appropriate scientific management of the Research Program; and

3.2.7. To manage and expedite the progress of Collaboration Products through the Research Program to development stages.

Section 3.3. *JRC Meetings*. The JRC shall act at meetings held regularly with all members present, according to the following:

3.3.1. JRC meetings shall take place at such times and places as shall be determined by the JRC at least twice a year; it is expected that the meetings will alternate between appropriate offices of each Party, or

at such other convenient locations as agreed;

3.3.2. If requested by a Party, the JRC may conduct a particular meeting by telephone or video conference or other acceptable electronic means, provided that all JRC members attend such meeting and can hear and communicate with all other members, and any decisions made during such meeting are recorded in writing and confirmed by signature of at least one of the JRC members from each of the Parties;

3.3.3. A Party may bring a reasonable number of additional representatives, in a nonvoting capacity, to attend appropriate JRC meetings, provided that such attendance is helpful to the JRC carrying out its tasks and obligations;

3.3.4. Before each meeting, the designated chair of the JRC (which may vary during the term) shall circulate an agenda for the meeting, and the JRC shall keep minutes reflecting matters discussed and the actions taken at the meeting, a copy of which shall be provided to each Party;

3.3.5. The JRC may act on a specific issue or matter without a meeting if the JRC members all agree on such action and such agreement is set forth in a written consent signed by all the members of the JRC;

3.3.6. The JRC may form and subsequently disband subcommittees to perform such tasks, within the authority of the JRC and on the JRC's behalf, as are specifically delegated by the JRC. For example, the JRC may create a subcommittee to address specific technical issues in the Research Plan. Any such subcommittee shall have appropriate representation of each Party and may include representatives of a Party who are not members of the JRC. All such subcommittees shall act only by unanimous agreement of their members at meetings as determined by the subcommittee. The subcommittees shall report all matters discussed and actions taken promptly to the JRC in writing. At the request of either Party at any time, any such subcommittee shall be dissolved and its powers and functions returned to the Research Committee.

Section 3.4. *Decision-Making and Issue Resolution*. All decisions of or actions taken by the JRC or any subcommittee thereof shall be by unanimous approval of all the members of the JRC or such subcommittee, and voting on any matters shall be reflected in the minutes of the meeting at which the vote was taken. If the JRC fails to reach unanimous agreement on an issue or matter needing resolution, the matter shall be referred for good faith discussion and resolution by the appropriate senior executive officer of each Party. If a subcommittee fails to reach unanimous agreement, the matter shall be referred for further review and resolution by the JRC.

Section 3.5. *Research Plan*. Promptly after its formation in accordance with Section 3.2, the JRC shall develop the initial Research Plan, which shall be provided to each Party for review and approval. The approved Research Plan shall then govern the initial work of the Parties under the Research Program and shall establish the number of full time equivalent employees ("FTEs") at Company B dedicated to conducting the Research Program, which number shall be 6 FTEs. The JRC shall periodically review the Research Plan in light of the results of the Research Program and modify, amend, or adjust the Research Plan as needed, provided that such modifications or amendments may not expand the scope of the Research Program unless agreed by the senior management of each Party. The Research Plan shall specify, among other things, the particular Company B Technology that shall be the subject of the Research Program, the specific scope and goals of the research and development work to be undertaken, the scientific direction, and research milestones, and shall give a general allocation between the Parties of the research responsibilities within such plan for the research.

Section 3.6. *Research Efforts and Expenses*. Each of the Parties shall maintain scientific staff, laboratories, offices, and other facilities necessary to carry out the Research Program tasks and obligations assigned to it by the JRC. Each party shall use Reasonable Efforts to conduct and complete such tasks and obligations and otherwise to achieve the goals of the Research Program. Company A shall bear all of its own expenses incurred in connection with the Research Program, including travel expenses. In addition, Company A shall provide to Company B funding to support the Research Program work at Company B. Such funding shall be at an FTE rate, based on the total number of FTEs allocated under the Research Plan to conduct work at Company B on the Research Program, providing that such funding shall be for a total of 6 FTEs unless otherwise agreed by the JRC. The FTE rate initially shall be $_ _[*amount*]_ _ per year per FTE. Such rate shall be adjusted upward or downward, commencing on the first January 1 after the Start Date, and every January 1 thereafter, in an amount to reflect any changes (from the last date that the FTE rate was set) in the consumer price index for urban wage earners in the _ _[*specify region*]_ _ region. Company A shall provide such funding in advance at the beginning of each calendar quarter during the Research Program. Company B shall provide

Company A a summary accounting of its FTE allocation to conduct the Research Program, within 60 days before the end of each year during the Research Term. At least 30 days before the beginning of each year during the Research Term, Company B shall submit to Company A a detailed budget, consistent with the budget described in the Research Plan approved by the JRC. Company B shall provide Company A with a detailed quarterly progress report within 30 days after the end of each calendar quarter.

Section 3.7. *Other Research*. Company B acknowledges and agrees that the specific research and development work set forth in the Research Plan will be conducted solely by Company B and Company A. Company A acknowledges and agrees that nothing in this Agreement shall prevent or otherwise hinder Company B from conducting, and Company B shall retain full rights to conduct, its own independent research and development work with respect to Company B Technology or any aspect thereof for any use or purpose, including conducting such research and development work with or on behalf of third party partners. Company B acknowledges and agrees that nothing in this Agreement shall prevent or otherwise hinder Company A from conducting, and Company A shall retain full rights to conduct, its own independent research and development work with respect to Company A Technology or any aspect thereof for any use or purpose, including conducting such research and development work with or on behalf of third party partners.

Section 3.8. *Licenses and Rights.*

3.8.1. *Research License to Company A*. Subject to the terms of this Agreement, Company B hereby grants to Company A a nonexclusive license (subject to the following restriction) under the Company B Technology that is the subject of the Research Program solely to conduct the Research Program activities assigned to Company A under the Research Plan. Company B further agrees that during the term of the Research Program Company B will not license to any Third Party any Company B Technology for use in pursuing any research activity that is expressly the subject of the Research Program.

3.8.2. *Research License to Company B*. Subject to the terms of this Agreement, Company A hereby grants to Company B a nonexclusive license (subject to the following restriction) under any applicable Company A know-how and Patent rights solely to conduct the Research Program activities assigned to Company B under the Research Plan. Company A further agrees that during the term of the Research Program Company A will not license to any Third Party any Company A Technology for use in pursuing any research activity that is expressly the subject of the Research Program.

3.8.3. *Commercial License to Company B*. Subject to the terms of this Agreement, Company A hereby grants to Company B the exclusive license in the Company B Territory under the Collaboration Technology to research, develop, make, have made, use, sell, offer for sale, and import Collaboration Products and Company B Products in the Company B Territory.

3.8.4. *Sublicenses to Third Parties*.

3.8.4.1. Company A shall have the right to grant sublicenses under the Collaboration Technology (i) to its Affiliates to develop, make, have made, use, sell, offer for sale, and import Collaboration Products and Company A Products in the Company A Territory without Company B's prior written approval, and (ii) to Third Parties solely for sale of Collaboration Products and Company A Products incorporating Collaboration Technology in the Company A Territory without Company B's prior written approval.

3.8.4.2. Company B shall have the right to grant sublicenses under the Collaboration Technology (i) to its Affiliates to develop, make, have made, use, sell, offer for sale, and import Collaboration Products and Company B Products in the Company B Territory without Company A's prior written approval, and (ii) to Third Parties solely for sale (but not therapeutic development) of Collaboration Products and Company B Products incorporating Collaboration Technology in the Company B Territory without Company A's prior written approval.

Section 3.9. *Fees and Royalties.*

3.9.1. *Sales of Collaboration Products by Company A*. Company A shall pay Company B a royalty equal to _ _[*number*]_ _ percent of the Net Revenue from Collaboration Products sold by Company A, its Affiliates, licensees, and Sublicensees in the Company A Territory. For each particular Collaboration Product, Company A shall pay the royalties specified above, on a country-by-country basis, until the later of the expiration of 10 years from the first commercial launch of such Collaboration Product in such country or the

last to expire of the Patents with claims covering such Collaboration Product or its manufacture or use in such country.

3.9.2. ***Sales of Collaboration Products by Company B*****. Company B shall pay Company A a royalty equal to _ _[*number*]_ _ percent of the Net Revenue of Collaboration Products sold by Company B, its Affiliates, licensees, and Sublicensees in the Company B Territory. For each particular Collaboration Product, Company B shall pay the royalties specified above, on a country-by-country basis, until the later of the expiration of 10 years from the first commercial launch of such Collaboration Product in such country or the last to expire of the Patents with claims covering such Collaboration Product or its manufacture or use in such country.**

3.9.3. ***Royalty Reduction*****. If Company A or Company B, as applicable, sells a particular Collaboration Product that does not meet the definition of a Company A Product or a Company B Product in a country where, at the time of sale, there is no issued Collaboration Patent that claims such Collaboration Product or its manufacture or use, then the amount of royalty owed by such Party to the other Party under Section 3.9.1 or 3.9.2 (as applicable) shall be reduced by _ _[*number*]_ _ percent with respect to such sale.**

3.9.4. ***Payment of Royalties*****. Royalties under this Article 3 shall accrue on the sale of the particular Collaboration Product (deemed to occur on the earlier of transfer of title or invoice date), and royalties that have accrued during a particular calendar quarter shall be paid by the Party owing such royalties within 60 days after the end of each such calendar quarter.**

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§6.49 4. Form: Intellectual Property

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6.49-1 Intellectual property

ARTICLE 4: INTELLECTUAL PROPERTY

Section 4.1. *Ownership*. Subject to the terms of this Agreement and any other Joint Venture Document, Company A shall own the entire right, title, and interest in and to the Collaboration Technology throughout the world, and Company B agrees to assign to Company A its entire interest in the Collaboration Technology, subject to the rights granted in Section 3.8.

Section 4.2. *Company A Responsibility for Patent Filings*. Company A shall use Reasonable Efforts to file, prosecute, issue, and maintain Collaboration Patents. In each event, Company A shall confer with Company B, and make Reasonable Efforts to adopt Company B's suggestions, regarding the prosecution of such Patents. On Company A's reasonable request and at its sole expense, Company B shall make Reasonable Efforts to assist Company A in the filing of any Collaboration Patent. In addition, Company A shall copy Company B with any official action and Company A submissions in such Patents. If Company A fails to file, prosecute, issue, or maintain a particular Collaboration Patent in the Company B Territory within 60 days of receipt of a request from Company B that Company A take such action, Company B shall have the right to file, prosecute, issue, or maintain such Collaboration Patent in the Company B Territory.

Section 4.3. *Enforcement Rights*. With respect to infringement of any of the Collaboration Patents in the Company A Territory, Company A shall have the initial right, but not the obligation, to institute, prosecute, and control any action or proceeding with respect to such infringement in the Company A Territory. Company A shall bear the costs of such patent enforcement within the Company A Territory and shall retain for its own account any amounts recovered from Third Parties. Company B shall have the right, but not the obligation, to institute, prosecute, and control any action or proceeding with respect to infringement in the Company B Territory. Company B shall bear the costs of patent enforcement within the Company B Territory and retain for its own account any amounts recovered from Third Parties. The Party first having knowledge of any infringement of the Collaboration Patents shall promptly notify the other Party in writing. The notice shall set forth the facts of such infringement in reasonable detail. If a Party having the right to enforce a Collaboration Patent under this Section 4.3 fails to bring an action or proceeding against a suspected infringer within a period of 90 days after having knowledge of such infringement in the Field, the other Party shall have the right to bring and control an action against such infringer by counsel of its own choice. If one Party brings any such action or proceeding, the other Party agrees to be joined as a Party plaintiff if necessary to prosecute the action and to give the first Party reasonable assistance and authority to file and prosecute the suit. The Party controlling a suit hereunder shall, at the other Party's expense, retain any and all recovery from such suit. The Party controlling a suit hereunder shall not settle or consent to an adverse judgment in any such action that would have a material adverse effect on the rights or interests of the other Party without the prior express written consent of the other Party.

Section 4.4. *Third Party Patent Rights*. Except as otherwise provided in this Agreement or any other Joint Venture Document, neither Party makes any warranty with respect to the validity, perfection, or dominance of any Collaboration Patent or other proprietary right or with respect to the absence of rights of Third Parties that may be infringed by the manufacture or sale of any Collaboration Product.

Section 4.5. *Third Party Claims in the Company A Territory*. If a Third Party asserts that a patent, trademark, or other intangible right owned by it is infringed by any Collaboration Product in the Company A Territory, Company A shall be solely responsible for defending against any such assertions at its cost and expense. Each Party shall give prompt written notice to the other of any such claim. Company B shall assist in the

defense of any such claim as reasonably requested by Company A, at Company A's expense, and may retain separate counsel at its own expense. Before settling any such claim, Company A shall consider in good faith any rights and interests of Company B that may be adversely affected by such settlement and shall use good faith efforts to minimize such effect.

Section 4.6. *Third Party Claims in the Company B Territory*. If a Third Party asserts that a patent, trademark, or other intangible right owned by it is infringed by any Collaboration Product in the Company B Territory, Company B shall be solely responsible for defending against any such assertions at its cost and expense. Each Party shall give prompt written notice to the other of any such claim. Company A shall assist in the defense of any such claim as reasonably requested by Company B, at Company B's expense, and may retain separate counsel at its own expense. Before settling any such claim, Company B shall consider in good faith any rights and interests of Company A that may be adversely affected by such settlement and shall use good faith efforts to minimize such effect.

Section 4.7. *Third Party Royalties*. In the event that a Party is required to obtain a license under a Third Party patent that covers or claims the manufacture, use, or sale of a Collaboration Product in order to practice a Collaboration Patent to sell such Collaboration Product as permitted in this Agreement, then provided that such Party discloses the relevant portions of such license under such Third Party patent to the other Party and (if applicable) the extent of any alleged infringement, such Party shall be entitled to deduct _ _[*number*]_ _ percent of any royalties owing to such Third Party based on the sale of such Collaboration Products under such license from amounts owing to the other Party, subject to a maximum royalty reduction of _ _[*number*]_ _ percent of the amounts that otherwise would be owed by such Party under this Agreement.

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§6.50 5. Form: Capitalization

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6.50-1 Capitalization

ARTICLE 5: CAPITALIZATION

Section 5.1. Capitalization. The authorized capital of the Joint Venture ("Authorized Capital") shall be formed from contributions of the Parties as described in this Article 5, having an aggregate value of $_ _[*amount*]_ _. The value of each Party's contribution to the Authorized Capital and each Party's Percentage of Ownership Interest shall be as follows:

Party	*Value in $*	*Percentage of Ownership Interest*
Company A	**$_ _[*amount*]_ _**	**_ _[*number*]_ _%**
Company B	**$_ _[*amount*]_ _**	**_ _[*number*]_ _%**

Section 5.2. *Contributions of Company B*. Subject to the conditions precedent specified in Section 5.4, Company B shall make its contribution to the Authorized Capital as follows. The Parties agree that the aggregate present value of Company B's contribution pursuant to this Section 5.2 is $_ _[*amount*]_ _.

5.2.1. By contributing the rights for use of the "Company B" trade name and various service marks (collectively, the "Marks") and its _ _[*description of other contribution of intellectual property rights*]_ _. Such contribution shall be made in accordance with a licensing agreement having a term equal to the duration of the Joint Venture and containing other terms and conditions satisfactory to both Parties. The Joint Venture shall not be obligated to pay any licensing fees or other charges to Company B for such contribution.

5.2.2. By equipping the Joint Venture Main Facility with a computer database and software system capable of keeping accurate records of all _ _[*description*]_ _.

5.2.3. By devising and contributing to the Joint Venture an overall system of control and coordination capable of ensuring _ _[*description*]_ _.

5.2.4. When Company B is promoting its other international services, by its promotion of the Joint Venture's business in a like manner through the inclusion of reference to its services in television campaigns, signs, promotional materials, and other advertisements generally describing Company B's _ _[*type of services*]_ _ services.

5.2.5. By contributing Company B _ _[*name of trademark*]_ _ signage developed and manufactured for display at specified Company A Branches.

Section 5.3. Contributions of Company A. Subject to the conditions precedent specified in Section 5.4 hereof, Company A shall make its contribution to the Authorized Capital as follows. The Parties agree that the aggregate present value of Company A's contribution under this Section 5.3 is $_ _[*amount*]_ _.

5.3.1. By contributing the use of the Facilities and related facilities of Company A for _ _[*provide description*]_ _ and for all other purposes contemplated by its objects, for a term equal to the duration of the Joint Venture and on such other terms and conditions as may be satisfactory to both Parties.

5.3.2. By causing the Joint Venture Main Facility to be leased or subleased to the Joint Venture pursuant to a lease satisfactory to both Parties having a term coterminous with the duration of the Joint Venture commencing not later than the date _ _[*number*]_ _ days after Formation. The Joint Venture shall not be obligated to pay any rental or other charges (including taxes or assessments imposed by any Governmental Authority or other Person) for such lease, all such rentals or other charges to be the sole responsibility of Company A and to be deemed part of Company A's contribution to the Authorized Capital.

5.3.3. By equipping the Joint Venture Main Facility with a telecommunications system (including all necessary domestic telephone lines and a full staff of operators, but excluding international lines referred to in Section 7.2.9) capable of supporting all necessary telecommunications between the Joint Venture Main Facility and the Facilities and between the Joint Venture Main Facility and Company B's central telephone bureaus in the United States and capable of ensuring that all messages received by the system are properly recorded and entered into the computer base. The Joint Venture shall not be obligated to pay any costs associated with the installation or staffing and operation of the domestic communication system or of the central telephone bureau (other than costs referred to in Section 7.2.9), all such costs to be the sole responsibility of Company A.

Section 5.4. *Conditions to Contributions*.

5.4.1. Neither of the Parties shall be obligated to make contributions under the preceding sections of this Article 5 unless it is satisfied that: (a) the Joint Venture Documents have been executed and delivered and any necessary Government Approvals have been obtained as required by Section 2.3 and are then in full force and effect; (b) no event shall have occurred that entitles it to terminate this Agreement in accordance with Section 13.1.2 or 13.1.3 (or which with notice or lapse of time or both would so entitle it); and (c) _ _[*specify any other conditions precedent*]_ _.

5.4.2. Company B shall not be obligated to make any of its contributions under Section 5.2 unless it has received evidence satisfactory to it that (a) it is possible, at a reasonable expense, to obtain and maintain (1) adequate protection for Company B's proprietary rights in respect of each of (i) the Marks, (ii) any of Company B's proprietary computer equipment, software, databases, and related documentation and materials that are material to Company B's operations, and (iii) any trade secrets or confidential information of Company B disclosed to the Joint Venture that are material to Company B's operations (and that all such steps as are reasonably practicable to ensure such protection at the time have been taken); and (2) any export licenses required by the United States; and (b) Company A has made or is then able to make each of its contributions to the Joint Venture as contemplated by Section 5.3.

5.4.3. Company A shall not be obligated to make any of its contributions under Section 5.3 unless it has received evidence satisfactory to it that Company B has made or is then able to make each of its contributions to the Joint Venture as contemplated by Section 5.2.

Section 5.5. *Ownership*. The Joint Venture shall be owned _ _[*number*]_ _ percent by Company B and _ _[*number*]_ _ percent by Company A (such ownership interests, as they may be modified in accordance with the terms of this Agreement, are hereafter referred to as the "Ownership Interests"). The Parties' Ownership Interests shall be effective as of the date of Formation on the basis of the agreement of the Parties to make contributions to the Authorized Capital as described in this Article 5.

Section 5.6. *Limitation on Transfer of Ownership Interest*. Each of the Parties agrees that it shall not sell any part of its Ownership Interest in the Joint Venture, except with the prior written consent of the other Party. The Joint Venture shall not recognize as a party to this Agreement any transferee of either Party's interest that was transferred other than in compliance with the terms and restrictions of this Section 5.6, and unless there has been such compliance, any transferee of such interest shall have no rights in the Joint Venture or under this Agreement.

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§6.51 6. Form: Management

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6.51-1 Management

ARTICLE 6: MANAGEMENT

Section 6.1. *The Board*.

6.1.1. The highest governing body of the Joint Venture shall be a Board consisting of _ _[*number*]_ _ members appointed by the Parties as follows: Company A shall appoint _ _[*number*]_ _ of the Board members and Company B shall appoint _ _[*number*]_ _ of Board members.

6.1.2. A member of the Board shall occupy his or her post for a term of _ _[*number*]_ _ years if he or she is not earlier recalled by the Party that appointed him. The terms of Board members may be renewed without limitation. The Parties may also designate one or more alternate members of the Board to serve in lieu of any regular member. Information on appointment or recall of Board members by any Party shall be forwarded immediately to the other Party by letter, telex, facsimile, or cable.

6.1.3. Except as otherwise provided herein, the Board shall determine its own structure and work procedures and shall select from among its members a Chairman and Vice Chairman.

6.1.4. The Board is empowered to take actions if any _ _[*number*]_ _ of the members are in attendance at a meeting personally or through representation by an alternate member appointed by the same Party, or by written proxy.

6.1.5. Regular meetings of the Board shall be held annually on or about _ _[*month*]_ _ and _ _[*month*]_ _ of each year. A special meeting of the Board shall be called whenever it is deemed necessary by the Chairman or when at least _ _[*number*]_ _ members of the Board have requested the Chairman in writing to call such a meeting to discuss matters specified in such request. Notice of each annual or special meeting shall be sent to the members not less than _ _[*number*]_ _ days in advance by the Chairman or Vice Chairman by telex, telegram, or facsimile with a statement of the matters to be considered.

6.1.6. Board meetings shall be conducted at the site of the Joint Venture or at such other locations named by the Chairman.

6.1.7. Resolutions of the Board may be adopted without a meeting through telex, facsimile, or telegram communications, provided that no member of the Board objects to such a procedure.

6.1.8. Minutes shall be taken at each Board meeting. Copies of the minutes and of all resolutions adopted by the Board shall be signed by the Chairman and Vice Chairman and distributed to all members of the Board.

6.1.9. The members of the Board shall not be compensated for their services in that capacity. Travel expenses of Board members shall be reimbursed by the Joint Venture.

6.1.10. All questions concerning the business activities of the Joint Venture are within the competence of the Board unless otherwise specified in this Agreement _ _[*or in the Articles*]_ _.

6.1.11. Each member of the Board shall have one vote, and, except as otherwise provided in this Agreement, actions of the Board shall require a simple majority.

6.1.12. Notwithstanding any other provision in this Agreement, actions of the Board with respect to the following matters shall be taken only by unanimous decision: (a) any amendment or other change to this Agreement or any other Joint Venture Document; (b) any increase or decrease in the amount of the Authorized Capital or request or declaration that the Parties must make additional contributions to the Joint Venture; (c) the establishment or liquidation of any branch or Affiliate of the Joint Venture; (d) the establishment of any special fund and the authorization of payments to or from any such fund; (e) any decisions with respect to collective bargaining agreements; (f) the suspension of business operations of the Joint Venture, or the merger, consolidation, or amalgamation of the Joint Venture with any other Person; (g) the appointment of liquidators for the Joint Venture, the determination of their powers and remuneration and the specification of procedures for the liquidation in accordance with Article 13; and (h) the execution and delivery by the Joint Venture of any Joint Venture Document, and any extension of the term of, or any other material amendment or modification to, any such document.

6.1.13. The Board may delegate any of its powers to Management except for the power to take action with respect to the matters enumerated in Section 6.1.12.

Section 6.2. *Management.*

6.2.1. The day-to-day management of the Joint Venture shall be in the charge of the Chief Executive Officer, the Chief Financial Officer, and such other officers as the Board shall determine. The Chief Executive Officer shall represent the Joint Venture in its dealings with third parties and shall be responsible for the implementation of the decisions of the Board.

6.2.2. All members of management shall be appointed by and shall serve at the pleasure of the Board and shall receive compensation determined by the Board.

6.2.3. The duties and responsibilities of Management are as follows: (a) the Chief Executive Officer shall be responsible for the implementation of the decisions of the Board and (subject to the authority of the Board) for the overall supervision and conduct of the day-to-day business of the Joint Venture; and (b) the Chief Financial Officer shall (i) submit to the Board not later than _ _[*number*]_ _ days after Formation the proposed Operating Plan for the first fiscal year, and by the end of each fiscal year the proposed Operating Plan for the following year, which the Board shall adopt (with any revisions that the Board may approve) within _ _[*number*]_ _ days after such submission; (ii) cause to be prepared, within _ _[*number*]_ _ days after the end of each fiscal quarter, _ _[*add if one party is foreign: two sets of*]_ _ quarterly financial statements, and within _ _[*number*]_ _ days after the end of each fiscal year,_ _[*add if one party is foreign: two sets of*]_ _ audited annual financial statements of the Joint Venture, consisting of a balance sheet, an income statement, and a cash flow statement, _ _[*add if one party is foreign: one set being*]_ _ prepared in accordance with generally accepted accounting principles in the United States _ _[*add if one party is foreign: and one set prepared in accordance with _ _[name of foreign country]_ _ accounting principles for joint ventures*]_ _; (iii) make any filings to appropriate Government Authorities as required by applicable law; (iv) maintain the Joint Venture's books and records in accordance with Section 9.2 of this Agreement; (v) disburse money in accordance with the Operating Plan; and (vi) manage the day-to-day financial matters of the Joint Venture. No material disbursement of the Joint Venture's money shall be made without the concurrence of the Chief Financial Officer.

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§6.52 7. Form: Further Obligations

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6.52-1 Further obligations

ARTICLE 7: FURTHER OBLIGATIONS

Section 7.1. *Further Obligations of Company B*.

7.1.1. Company B shall supervise, direct, and administer all necessary arrangements relating to the Parties' goal of developing through the Joint Venture _ _[*description of development plans*]_ _.

7.1.2. Company B (together, if necessary, with external consultants to be compensated by the Joint Venture) shall assist the Joint Venture in developing further systems required in connection with any expansion of the Joint Venture's purposes as described in Recital A, including (to the extent required) _ _[*description of additional systems*]_ _.

7.1.3. Company B shall assist the Joint Venture in the procurement of technology, goods, and services from foreign suppliers on a timely basis as necessary in connection with the purposes of the Joint Venture, including the negotiation of any necessary agreements relating to the sale, purchase, lease, license, use, employment, or other transfer to the Joint Venture of foreign-supplied goods and services.

7.1.4. With respect to imports into _ _[*specify nation(s)*]_ _ of computer equipment and other foreign-supplied technology, materials, supplies, machinery, equipment, or other goods required by the Joint Venture, Company B shall assist the Joint Venture in obtaining all documentation, customs clearances, permits, and approvals that are from time to time required by the country or countries from which such goods are exported.

7.1.5. Company B shall assist in training the personnel of the Joint Venture in the use and operation of the foreign-supplied goods and technology procured by it as contemplated above and in the planning, management, and operational techniques required for the _ _[*provide description*]_ _ system of the Joint Venture.

7.1.6. Company B shall supervise the marketing and advertisement of the Joint Venture's services in foreign markets, including the development of, and negotiation with, external marketing consultants and advertising agencies regarding appropriate promotional activities (it being understood and agreed that the Joint Venture shall be responsible to pay the commissions charged by such consultants and agencies and all other costs of such activities other than _ _[*describe any excluded costs*]_ _.

7.1.7. Company B shall be credited with _ _[*number*]_ _ percent of the revenue from _ _[*provide description*]_ _ for its expenses, although such expenses are not be required to be itemized.

Section 7.2. *Further Obligations of Company A*.

7.2.1. Company A shall make all necessary arrangements with appropriate authorities in _ _[*specify location*]_ _ to ensure that the Joint Venture has at its disposal (on terms satisfactory to it) all facilities necessary to _ _[*provide description*]_ _.

7.2.3. Company A shall obtain or cause to be obtained all Governmental Approvals required from any Governmental Authority in connection with the operations and activities of the Joint Venture (including any Governmental Approvals required to permit distributions contemplated by Section 8.2) or in connection with the performance by any Joint Venture Participant of its obligations under any Joint Venture Document.

7.2.4. Company A shall not contract any competing service which performs _ _[*provide description of service*]_ _ throughout the territory of _ _[*name of territory*]_ _ (whether originated domestically or from abroad). If and to the extent requested by the Board to do so, Company A shall assist the Joint Venture in obtaining any Governmental Approvals necessary to expand its purposes as described in Recital A.

7.2.5. Company A shall use its best efforts to ensure that the Joint Venture obtains all import documentation, customs clearances, and local transportation from time to time necessary for the importation into _ _[*specify nation*]_ _ of any equipment, materials, or other items required by the Joint Venture.

7.2.6. Company A shall use its best efforts to assist the Joint Venture in procuring all legal invitations necessary to obtain travel visas to _ _[*specify nation*]_ _ for personnel, consultants, and prospective customers and suppliers of the Joint Venture and arranging for multi-entry/multi-exit visas for such persons who will reside in or travel regularly to the _ _[*name of region*]_ _. Company A shall also assist the Joint Venture in arranging for suitable accommodations, transportation, and other services for such persons while they are in the _ _[*name of region*]_ _.

7.2.7. Company A shall select and provide suitable staff, subject to the approval of the Board, for carrying out the day-to-day operations of the Joint Venture.

7.2.8. Company A shall arrange for the Joint Venture to obtain from _ _[*provide description*]_ _ suppliers, for _ _[*provide description*]_ _ at customary domestic rates, all utilities (including electricity, fuel, water, and telecommunications), materials, supplies, machinery, equipment, inventory, labor, and services required by the Joint Venture on a timely basis as necessary for the Joint Venture to carry out its operations (excluding any of the foregoing that are to be procured by Company B in accordance with Section 7.1).

7.2.9. Company A shall assist the Joint Venture in obtaining direct international telephone lines (it being understood and agreed that the costs of installing and utilizing such lines, including periodic lease and usage charges, shall be borne by the Joint Venture).

7.2.10. Company A shall arrange for the Company B _ _[*name of trademark*]_ _ signage contributed pursuant to Section 5.2.5 hereof to be prominently displayed at all Facilities.

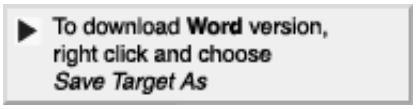
7.2.11. Company A shall assist Company B, to the extent reasonably possible, in obtaining and maintaining protection and registrations in _ _[*specify nation*]_ _ for Company B's proprietary rights in respect of (a) the Marks, (b) any of Company B's proprietary computer equipment, software, databases, or other related documentation and materials that are material to the operation of the Joint Venture, and (c) any other trade secrets or confidential information of Company B that are material to the operation of the Joint Venture.

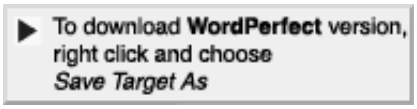
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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.53 8. Form: Financial Matters

§6.53 8. Form: Financial Matters

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6.53-1 Financial matters

ARTICLE 8: FINANCIAL MATTERS

Section 8.1. *Past Expenses*. Prior to Formation, each Party shall bear its own expenses incurred in connection with the transactions contemplated in this Agreement. Following Formation, all reasonable expenses incurred by the Parties for and on behalf of the Joint Venture and as set forth in the Operating Plan then in effect shall be for the account of the Joint Venture and shall be reimbursed by the Joint Venture to such Party in the currency in which incurred.

Section 8.2. *Distribution Policy*. The Parties agree that the Board shall distribute to each Party its share (based on the Parties' respective Ownership Interests) of all net profits of the Joint Venture (after the payment of applicable taxes and withholding any amounts owing from such Party to the Joint Venture). The Parties shall promptly file, and shall cause the Joint Venture to file, such applications or other documents and to take any other action that may be necessary to obtain any Governmental Approvals as may be required for the remittance _ _[*(and in the case of Company B, the repatriation)*]_ _ of any such distributions as promptly as practicable.

Section 8.3. *Fiscal Year*. The fiscal year of the Joint Venture shall end on _ _[*date*]_ _ of each year.

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§6.54 9. Form: Financial Statements and Records

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6.54-1 Financial statements and records

ARTICLE 9: FINANCIAL STATEMENTS AND RECORDS

Section 9.1. *Operating Plan*. The Chief Financial Officer shall submit to the Board not later then _ _[*number*]_ _ days after Formation the proposed capital and operating budget (an "Operating Plan") for the first fiscal year, and shall submit by the end of each fiscal year an Operating Plan for the following year, which in each case shall specify (among other things) the capital spending planned for such year and any reserves to be established and maintained, and which the Board shall adopt (with such revisions as the Board may approve) within _ _[*number*]_ _ days after the submission of such budgets to it.

Section 9.2. *Books and Records.*

9.2.1. The Joint Venture shall maintain separate accounting records for the entry of all transactions relating to its business and operations. Such records shall be maintained in accordance with generally accepted accounting principles in the United States _ _[*provided that sufficient additional records shall be maintained in accordance with _ _[nation's]_ _ accounting requirements applicable to joint ventures*]_ _.

9.2.2. The accounting records shall be audited annually by a _ _[*provide description*]_ _ auditing agency designated by the Board. The fees and expenses of such audits shall be borne by the Joint Venture.

9.2.3. The accounting records of the Joint Venture shall be kept at its legal address. Each Party or its duly authorized representative(s) shall have access to the complete accounting records of the Joint Venture and all supporting documentation at all reasonable times during normal business hours of the Joint Venture, and shall be entitled to make photocopies or extracts thereof. Each Party shall have the right to remove such copies or extracts from the _ _[*specify location*]_ _.

Section 9.3. *Financial Statements*. The Chief Financial Officer shall cause to be prepared within _ _[*number*]_ _ days after the end of each fiscal quarter, quarterly, and within _ _[*number*]_ _ days after the end of each fiscal year, audited annual financial statements for the Joint Venture, consisting of a balance sheet, an income statement, and a cash flow statement. _ _[*Number*]_ _ sets of each of such financial statements shall be prepared in accordance with Section 9.2(a) hereof. _ _[*To the extent required by _ _[specify nation]_ _'s law, the Chief Financial Officer shall submit annual financial statements prepared in accordance with _ _[specify nation]_ _'s accounting requirements to the appropriate government authorities within the time period(s) specified by such relevant laws and regulations.*]_ _

Section 9.4. *Taxes*. The tax records of the Joint Venture shall be prepared in accordance with the laws and regulations of _ _[*specify nation*]_ _ by a qualified professional accountant approved by the Chief Executive Officer. The Joint Venture shall supply each Party with copies of the Joint Venture's tax returns for review before such returns are filed with the appropriate government authorities and with certified or stamped copies of all of its tax returns as filed.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.55 10. Form: Representations and Warranties

§6.55 10. Form: Representations and Warranties

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6.55-1 Representations and warranties

ARTICLE 10: REPRESENTATIONS AND WARRANTIES

Section 10.1. *Representations and Warranties of Company B*. Company B represents and warrants to and for the benefit of Company A (as of the date of this Agreement and the date of each contribution made under Article 5) as follows:

10.1.1. Company B is a corporation duly incorporated and validly existing under the laws of _ _[*specify jurisdiction*]_ _ and qualified to do business in _ _[*specify jurisdiction*]_ _, and has full legal right, power, and authority to enter into, and to perform its obligations under, this Agreement and the other Joint Venture Documents to which it is a party.

10.1.2. This Agreement and each other Joint Venture Document to which it is a party have been duly authorized by all necessary corporate action (including shareholder approval, if necessary) of Company B, have been executed by a duly authorized representative of Company B, and constitute legal, valid, and binding obligations of Company B, enforceable in accordance with their terms.

10.1.3. The execution, delivery, and performance of this Agreement by Company B do not violate any provisions of (a) Company B's articles of incorporation or bylaws, (b) any contract or instrument to which Company B is a party or by which it or any of its assets are bound, or (c) any laws or regulations applicable to Company B's business.

10.1.4. No approvals, consents, or licenses are required to be obtained by Company B in the United States in order to enable Company B to enter into this Agreement and perform its obligations under this Agreement (except as provided in Section 16.2) and the other Joint Venture Documents.

Section 10.2. *Representations and Warranties of Company A*. Company A represents and warrants to and for the benefit of Company B (as of the date of this Agreement and the date of each contribution made under Article 5) as follows:

10.2.1. Company A is a corporation duly organized and validly existing under the laws of _ _[*specify jurisdiction*]_ _ and qualified to do business in _ _[*specify jurisdiction*]_ _, and has full legal right, power, and authority to enter into, and to perform its obligations under, this Agreement and the other Joint Venture Documents to which it is a party.

10.2.2. This Agreement and each other Joint Venture Document to which it is party have been duly authorized by all necessary corporate action (including shareholder approval, if necessary) of Company A, have been executed by a duly authorized representative of Company A, and constitutes legal, valid, and binding obligations of Company A, enforceable in accordance with their terms.

10.2.3. The execution, delivery, and performance by Company A of this Agreement and each other Joint Venture Document to which it is party do not violate any provisions of (a) Company A's articles of incorporation or bylaws, (b) any contract or instrument to which Company A is a party or by which it or any of its assets are bound, or (c) any laws or regulations applicable to Company A's business.

10.2.4. Company A has obtained any Governmental Approvals necessary for Company A and Company B to execute and deliver, and to perform their respective obligations under, this Agreement and each other

Joint Venture Document to which they are parties for the establishment, ownership, funding, and operation of the Joint Venture.

10.2.5. On Formation, the Joint Venture shall be established, shall be fully authorized to conduct its business in _ _[*specify jurisdiction*]_ _, and shall have all of the other rights and powers of a juridical entity constituted under the Act.

10.2.6. Company A has all right, title, and interest in the Joint Venture Main Facility and all other property to be conveyed to the Joint Venture in accordance with Section 5.3. Such assets are not subject to any liens, security interests, charges, or other encumbrances. On transfer of such assets to the Joint Venture, the Joint Venture shall have all the right, title, and interest of Company A in such assets, free and clear of any liens, security interests, charges, or other encumbrances.

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§6.56 11. Form: Dispute Resolution

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6.56-1 Dispute resolution

ARTICLE 11: DISPUTE RESOLUTION

Section 11.1. *Submission to Arbitration*. Any disputes, differences, or questions arising between the Parties relating to the performance, interpretation, or construction of this Agreement (collectively, "Disputes") shall be settled amicably in the first instance. If amicable settlement cannot be reached within _ _[*number*]_ _ days following written notice by one Party to the other of the existence of any such Dispute, the same may be referred by either Party to binding arbitration in accordance with _ _[*specify designation of arbitration rules*]_ _ Arbitration Rules in _ _[*provide location of arbitration proceedings*]_ _ before a Board of Arbitration consisting of three arbitrators. Each Party shall appoint one arbitrator. The two arbitrators thus appointed shall appoint the third arbitrator who shall serve as Chairman of the Board of Arbitration. If a Party fails to appoint its arbitrator within a period of _ _[*number*]_ _ days after the other Party has appointed its arbitrator, or if the two arbitrators cannot agree on the third arbitrator within a period of _ _[*number*]_ _ days after appointment of the second arbitrator, the arbitrator of the failing Party or the third arbitrator shall be appointed by _ _[*specify person, e.g., chief judge of a designated court*]_ _.

Section 11.2. *Procedure for Arbitration*. The arbitration shall be conducted in the English language and shall take place under the auspices of _ _[*provide description*]_ _ in _ _[*specify location of arbitration*]_ _. The Board of Arbitration shall decide by majority on points of substance, law, and otherwise, and shall state the reasons for its decisions in writing. All decisions of the Board of Arbitration shall be final and binding on the Parties and may be entered against them in a court of competent jurisdiction. The Board of Arbitration shall determine the costs of arbitration in its award, and such costs shall be allocated to the Parties as determined by the Board of Arbitration. Either Party may publicize or otherwise disclose to others the contents of any decisions of a Board of Arbitration.

Section 11.3. *Continuing Obligations*. Neither the existence of any dispute, controversy, or claim, nor the fact that arbitration is pending, shall relieve any Party of its respective obligations under this Agreement.

Section 11.4. *Submission to Jurisdiction*. Each Party agrees that any judgment rendered by the arbitrators against it and entered in any court in _ _[*name of state*]_ _ may be executed against its assets in any jurisdiction. Each Party irrevocably submits to the nonexclusive jurisdiction of the courts of _ _[*name of state*]_ _, or any other jurisdiction, in any legal action or proceeding relating to such execution of judgment. Each Party designates _ _[*name*]_ _ as its agent to receive, for and on its behalf, service of process in any legal action or proceeding relating to such execution of judgment. Each Party irrevocably consents to service of process out of _ _[*name of state*]_ _ courts, or the courts of any other jurisdiction, in any such action or proceeding by the mailing of copies of such process by registered mail, postage prepaid, to it. The foregoing provisions, however, shall not limit the right of either Party to serve process in any other manner permitted by law, to commence any legal action or proceeding, or to obtain execution of judgment in any appropriate jurisdiction. Each Party irrevocably waives, to the fullest extent permitted by law, any objection that it may have to any suit, action, or proceeding arising out of or relating to the enforcement of an arbitral judgment under this Agreement being brought in _ _[*name of state*]_ _ or in any other jurisdiction in which it has assets, and further irrevocably waives any claim that any such suit, action, or proceeding has been brought in an inconvenient forum.

Section 11.5. *Waiver of Immunity*. Company A hereby agrees that all of the transactions contemplated by this Agreement shall constitute, and shall be deemed to constitute, commercial activities. To the extent that Company A may be entitled in any jurisdiction to claim or permit to be claimed immunity for itself or any of its

agencies, instrumentalities, properties, or assets, whether characterized as sovereign or otherwise, or as arising from an act of state or sovereignty, from suit, execution, setoff, attachment, or other legal process of any nature, it hereby expressly and irrevocably waives such immunity and hereby agrees not to claim or permit to be claimed any such immunity on its behalf or on behalf of such agencies, instrumentalities, properties, or assets. Without limiting the foregoing, Company A hereby expressly waives any right to claim immunity under the laws of _ _[*specify nation*]_ _ or any similar law in any other jurisdiction in the world. The waiver contained in this Section 11.5 shall be deemed to be made and repeated as if advanced as an express waiver in each instance of every claim asserted under this Agreement.

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§6.57 12. Form: Term\

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6.57-1 Term

ARTICLE 12: TERM

Section 12.1. *Term*. The term of this Agreement shall commence on the date hereof and, unless terminated under Article 13, shall be perpetual. The duration of the Joint Venture shall terminate simultaneously with the termination of this Agreement.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.58 13. Form: Termination and Liquidation

§6.58 13. Form: Termination and Liquidation

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6.58-1 Termination and liquidation

ARTICLE 13: TERMINATION AND LIQUIDATION

Section 13.1. *Termination and Liquidation*.

13.1.1. This Agreement shall terminate _ _[*number*]_ _ days after issuance of a notice of termination ("Termination Notice") in accordance with Section 13.1.2, Section 13.1.3, or Section 13.1.4, provided that such Termination Notice has not then been revoked by the Party that issued it before the expiration of such _ _[*number*]_ _-day period.

13.1.2. Company A shall be entitled to terminate this Agreement under Section 13.1.1 by issuing a Termination Notice to Company B, with a copy to the Joint Venture, following the occurrence of any of the following events: (a) the material breach by Company B of any of its obligations under Section 5.2, or the material breach by Company B of any of its other obligations under this Agreement or any other Joint Venture Document if not cured within _ _[*number*]_ _ days after Company B's receipt of written notice of such breach from Company A (which notice shall set forth in reasonable detail the facts forming the basis of the breach); (b) any representation or warranty made by Company B in this Agreement or in any other Joint Venture Document shall have been inaccurate when made in any material respect; (c) an event of Force Majeure shall have occurred entitling Company A to terminate under Section 14.1; (d) any Law is enacted by any Governmental Authority that so increases rates of taxation or costs of operation as (in the determination of Company A) to render the Joint Venture economically unjustifiable, or any other event occurs that (in the determination of Company A) makes it impracticable for the Joint Venture to carry on its business in a manner consistent with its objects; or (e) the Parties fail to agree on an adjustment regarding their economic benefits under Section 15.2 after an event adversely affecting Company A's economic interests.

13.1.3. Company B shall be entitled to terminate this Agreement under Section 13.1.1 by issuing a Termination Notice to Company A, with a copy to the Joint Venture, following the occurrence of any of the following events: (a) the material breach by Company A of any of its obligations under Section 5.3 or under any other Joint Venture Document if not cured within _ _[*number*]_ _ days after Company A's receipt of written notice of such breach from Company B (which notice shall set forth in reasonable detail the facts forming the basis of the breach); (b) any representation or warranty made by Company A in this Agreement or in any other Joint Venture Document shall have been inaccurate when made in any material respect; (c) an event of Force Majeure shall have occurred entitling Company B to terminate under Section 14.1; (d) any Law is issued by any Governmental Authority that so increases rates of taxation or costs of operation as (in the determination of Company B) to render the Joint Venture economically unjustifiable, or any other event occurs that (in the determination of Company B) makes it impracticable for the Joint Venture to carry on its business in a manner consistent with its objects; or (e) the Parties fail to agree on an adjustment regarding their economic benefits pursuant to Section 15.2 after an event adversely affecting Company B's economic interests.

13.1.4. This Agreement shall also terminate under Section 13.1.1 if such termination is mutually agreed on in a written notice from both Parties to the Board.

Section 13.2. *Liquidation Procedures*. On termination of this Agreement under Section 13.1, the Joint Venture shall be liquidated. The Board shall appoint a team of liquidators and shall determine their powers and remuneration and the procedures for liquidation. The team of liquidators shall consist of _ _[*number*]_ _ members, _ _[*number*]_ _ to be appointed to represent each Party and one to act as a deciding vote. If the Board fails to appoint _ _[*number*]_ _ or more of the liquidators within _ _[*number*]_ _ days after delivery of a

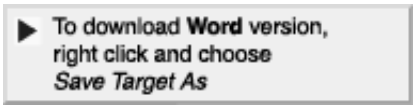
Termination Notice or a notice from the Parties under Section 13.1.4, then the liquidators shall be appointed by the Board at the request of either Party. The team of liquidators shall act jointly but not separately. The liquidation decisions of the Board shall be binding on the Parties, the liquidators, and the Joint Venture. The proceeds of the liquidation (including any proceeds obtained as the result of any exercise by the Joint Venture of its rights under any Joint Venture Document) shall be applied in accordance with Section 8.2. Notwithstanding the foregoing, in the event of liquidation, Company B shall have the right, but not the obligation, to repurchase at book value (net of accumulated depreciation) any equipment, technology, or other property acquired by the Joint Venture from the proceeds of Company B's contributions to the Authorized Capital within the limits of its investment in the Joint Venture. After liquidation, the liquidators shall prepare and submit to the Board for adoption a report detailing the liquidation of the Joint Venture. After such adoption, the Board shall submit such report to the Board and shall complete all steps necessary to terminate the Joint Venture as a separate juridical entity.

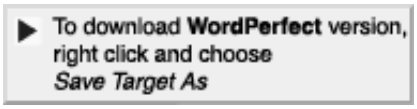
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§6.59 14. Form: Force Majeure

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6.59-1 Force majeure

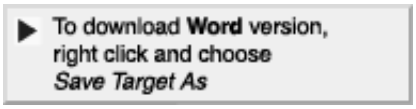
ARTICLE 14: FORCE MAJEURE

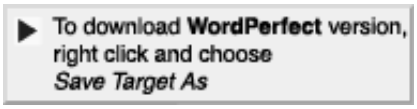
Section 14.1. *Force Majeure*. Neither Party shall be liable for nonperformance or delay in performance of any obligation under this Agreement if such nonperformance or delay is caused by an event of Force Majeure. The Party affected shall give prompt notice (together with any notice or information it has received regarding the Force Majeure event) to the other Party, advising it of the occurrence and effects of the event of Force Majeure, and shall use all reasonable efforts to minimize any adverse consequences resulting from the event of Force Majeure. When an event of Force Majeure is of such a nature that (a) the objectives of this Agreement and of the Joint Venture are substantially impaired and (b) the affected Party's performance is impaired for more than _ _[*number*]_ _ consecutive days, the Party whose performance has not been impaired shall have the right to issue a Termination Notice pursuant to Section 13.1.

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§6.60 15. Form: Changes in Law

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6.60-1 Changes in law

ARTICLE 15: CHANGES IN LAW

Section 15.1. *Favorable Changes*.

15.1.1. In the event any Governmental Authority having jurisdiction shall adopt any law, decree, regulation, or policy more favorable than the Act or than other laws, decrees, regulations, or policies previously applicable to Company B or the Joint Venture, then Company B or the Joint Venture, as the case may be, shall be entitled to apply (if application is necessary) to the appropriate Governmental Authority to receive the benefit of such law, decree, regulation, or policy.

15.1.2. The Joint Venture shall have a right of first refusal with regard to the purchase of the Joint Venture Main Facility or any other real estate occupied or otherwise used by the Joint Venture in the event that such purchase is allowed under the laws of _ _[*name of state*]_ _.

Section 15.2. *Adverse Changes*. In the event any Governmental Authority having jurisdiction adopts any new, or makes changes in existing, Law or policy that adversely affects either Party's economic interests under this Agreement, the Parties shall consult together and adjust the economic benefits between them under this Agreement. If the Parties are unable to agree on an adjustment to the economic benefits within _ _[*number*]_ _ days after the action of the Governmental Authority, Company B shall be entitled to issue a Termination Notice under Section 13.1.3(e) and Company A shall be entitled to issue a Termination Notice pursuant to Section 13.1.2(e).

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§6.61 16. Form: General Provisions

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6.61-1 General provisions

ARTICLE 16: GENERAL

Section 16.1. *Indemnity*. Each Party shall indemnify and hold harmless the Joint Venture, the other Party, and their respective directors, officers, employees, actually authorized representatives, and agents from and against any and all costs, losses, claims, obligations, damages, and liabilities (including reasonable attorney fees) incurred by either of them arising out of or in respect of any act, failure to act, or any assumption of any obligation or responsibility by such indemnifying Party, or by any of its directors, officers, or employees, that is in contravention or violation of or in conflict with any of the terms or provisions of this Agreement, provided that neither Party shall be obligated to indemnify the other Party for any of the foregoing matters caused by the gross negligence or willful misconduct of the other Party. Without limiting the generality of the foregoing, Company A hereby agrees for the benefit of the Joint Venture and Company B to indemnify and hold the Joint Venture harmless against, and reimburse it for, any and all rental or other charges (including taxes or assessments imposed by any Governmental Authority or other Person) claimed or asserted by any Person against the Joint Venture for its use of the Joint Venture Main Facility owned by Company A.

Section 16.2. *Export Controls*. The Parties acknowledge that the sale or transfer by Company B or by any other foreign party arranged by Company B (an "Exporter") of certain equipment and technology originating from _ _[*specify nation*]_ _ or from _ _[*specify other nations*]_ _, and the disclosure by an Exporter of certain technology and technical data originating from _ _[*specify nation*]_ _ or from _ _[*specify other nations*]_ _, to Company A or the Joint Venture may require the approval of one or more governmental authorities in _ _[*specify nation*]_ _ or such other countries and agree that, anything in this Agreement to the contrary notwithstanding, no Exporter shall be obligated to sell or otherwise transfer such equipment and technology or to disclose such technology or data unless and until such approvals are obtained.

Section 16.3. *Confidentiality*. Each Party (on behalf of itself and each of its affiliates, directors, officers, employees, and representatives) agrees to use reasonable precautions to keep confidential, and to cause the Joint Venture to keep confidential, any nonpublic information, proprietary information, or intellectual property supplied to it or to the Joint Venture by the other Party in accordance with this Agreement or the transactions contemplated hereby; provided, however, that nothing in this Agreement shall limit the disclosure of any such information (a) to the extent required by statute, rule, regulation, or judicial process; (b) to such Party's legal counsel; (c) to the other Party; (d) in connection with any litigation to which any Party is a party; or (e) to any permitted successor in interest of a Party, or to any permitted purchaser of a Party's ownership interest, provided that such successor or purchaser first executes and delivers to the Party that has an interest in keeping such information confidential an agreement to comply with the terms of this Section 16.3. In the event that disclosure shall be made pursuant to clauses (a), (d), or (e) above, the disclosing Party shall notify the other Party in advance of such disclosure.

Section 16.4. *Assignment*. This Agreement shall be binding on the Parties and their respective successors and permitted assigns. Neither Party shall have the right to assign or transfer any right or obligation under this Agreement without the prior written consent of the other Party. Any such attempted assignment or transfer in violation of this Section 16.4 shall be void and without legal effect. Anything in this Agreement to the contrary notwithstanding, each Party shall have the right to assign all or any part of its rights and obligations hereunder to any of its Affiliates or to one or more financial institutions as security for any loans made to finance any part of such Party's contributions to the Authorized Capital. The Party wishing to assign shall notify the other Party of each such assignment, and the other Party, at the request of the assigning Party, shall provide its consent to such assignment in form and substance satisfactory to the assigning Party as long as such assignment has no deleterious effect on the operations of the Joint Venture or on the other Party.

Section 16.5. *Entire Agreement*. This Agreement, together with its attachments, constitutes the entire understanding of the Parties with respect to the subject matter of this Agreement and supersedes all prior negotiations and understandings between the Parties, whether written or oral. No amendment to this Agreement shall be effective unless it is in writing and executed by both Parties, and is otherwise made in accordance with Section 6.1.12.

Section 16.6. *Severability.* If any one or more provisions of this Agreement are held to be invalid, illegal, or unenforceable in any respect, the validity, legality, and enforceability of the remaining provisions contained herein shall not in any way be affected or impaired; provided, however, that in such case the Parties agree to use their best efforts to achieve the purpose of the invalid provision by a new, legally valid provision.

Section 16.7. *No Waiver*. No failure or delay on the part of either Party in the exercise of any right under this Agreement shall operate as a waiver thereof, nor shall any such single or partial exercise of any such right preclude any other or future exercise thereof or of any other right. All rights and remedies under this Agreement are cumulative to, and not exclusive of, any rights or remedies otherwise available.

Section 16.8. *Notices*. Except as otherwise specified in this Agreement, all notices, requests, approvals, consents, and other communications required or permitted under this Agreement shall be in writing and shall be sent to a Party at its fax number specified below. A copy of any such notice shall also be personally delivered or sent by (a) first class U.S. mail, registered or certified, return receipt requested, postage prepaid, or (b) U.S. express mail, Federal Express, or other, similar overnight bonded mail delivery services to the address specified below:

If to Company A: _ _[*Address*]_ _
_ _[*Fax number*]_ _

If to Company B: _ _[*Address*]_ _
_ _[*Fax number*]_ _

Either Party may change its address or fax number for notification purposes by giving the other Party notice of the new address or fax number and the date on which it will become effective.

Section 16.9. *Further Assurances*. The Parties shall in a timely manner and as required from time to time take all such actions as may be necessary or appropriate to cause the Joint Venture to implement the transactions contemplated by this Agreement and to ensure that the Joint Venture takes all actions as may be necessary to give full effect to the provisions of this Agreement and to cause the Joint Venture to comply with applicable law, and shall abstain from taking any actions that would contravene the intent of the provisions of this Agreement.

Section 16.10. *Governing Law*. This Agreement shall be governed by, and construed in accordance with, the Act; provided, however, that in the event that any dispute arising under this Agreement between the Parties is submitted for arbitration and the arbitrators determine that there exists no provision of the Act applicable to the issue in dispute, then such issue shall be governed by, and construed in accordance with, _ _[*name of state*]_ _ law, without regard to _ _[*name of state*]_ _ conflicts of law rules.

Section 16.11. *Headings*. The article and section headings in this Agreement are for convenience only and shall not control or affect the meaning or construction of any provision of this Agreement.

Section 16.12. *Counterparts*. This Agreement may be executed in multiple counterparts, each of which shall be deemed an original, and all of which together shall constitute one and the same instrument.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.62 17. Form: Signatures

§6.62 17. Form: Signatures

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6.62-1 Signatures

IN WITNESS WHEREOF, the Parties have caused this Agreement to be executed by their duly authorized representatives on the date first above written.

Date: _ _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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V. STRATEGIC ALLIANCES; COLLABORATION AGREEMENTS

§6.63 A. Introduction

In many instances, intellectual property-focused companies find it to their advantage to collaborate with other companies in joint projects without the formation of a new legal entity. These so-called strategic alliances may also be referred to as collaboration agreements, development agreements, or teaming agreements, and the names may or may not reflect the substance of the underlying contractual relationship. For an overview of the major considerations in intellectual property collaborations, see §§3.34-3.38. See also the illustrative term sheet for a collaboration in §3.61. As a common denominator, strategic alliances or collaborations involve: (1) sharing the intellectual property rights of each party, or combining the intellectual property rights of one party with the resources (such as research, manufacturing, or distribution capabilities) of the other party, and (2) pursuing a new research project or business endeavor conducted jointly by the parties, usually accompanied by the creation of new intellectual property rights. An example of a strategic alliance or collaboration agreement is presented in §§6.78-6.92. Note that many provisions of the form of joint venture agreement in §§6.46-6.62 may also be useful examples for a collaboration.

If the strategic alliance engages in activities outside the United States, the parties must address a host of additional issues, such as export controls, restrictions on data transfers, and tax issues, which are not addressed in this chapter. For discussion of selected international issues, see chap 11.

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§6.64 B. Limited Relationship

A significant consideration in electing to form a strategic alliance rather than a joint venture or other legal entity is often the parties' intent that their relationship be limited, either with respect to the term of its existence or with respect to the scope of its activities. Because a strategic alliance or collaboration agreement is not a legal entity, but rather a contractual relationship, its term is limited to the duration of the contract and the scope of its activities is limited to what is provided in the contract.

The participants in a formal joint venture, *i.e.,* one organized as a separate legal entity, may also limit the term of its existence and the scope of its activities, but additional complications arise beyond the mere expense of forming and maintaining the entity. Significantly, the parties to a joint venture may owe each other fiduciary duties as limited liability company members or partners, which can be a distinct disadvantage for companies who are otherwise competitors joining in a common enterprise on a one-time basis. See §§6.7, 6.12-6.13. See §6.74 for discussion of when a jointly conducted business enterprise might be classified as a partnership.

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§6.65 C. Contributions

The strategic alliance or collaboration agreement must describe each party's contributions to the joint endeavor, which may include, in addition to intellectual property, a broad range of services and materials, such as development and testing services; equipment; software; support and engineering services; employee training; development and distribution of marketing materials; creation and management of a co-branded website and e-commerce fulfillment; creation and acquisition of website content; customer lists and leads; attending trade shows; sales and advertising services; and responsibility for regulatory compliance.

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§6.66 1. Defining Intellectual Property Rights

Strategic alliances or collaborations in the technology industries typically involve a contribution by the parties of some of their existing intellectual property to the collaboration and then a joint effort to develop new intellectual property. Because strategic alliances do not involve creation of a new legal entity, the manner in which intellectual property rights are addressed in the parties' agreement may create ambiguities if not carefully drafted. One of the key features of the parties' agreement will be clear definitions of each party's separate intellectual property as well as the intellectual property created by the collaboration. See, *e.g.,* the definitions in §6.78. See also §6.46.

The parties need to address the question of how intellectual property developed during the course of the collaboration will be owned. Unless otherwise agreed, intellectual property rights jointly created by the parties to the strategic alliance will usually be deemed to be jointly owned by the parties, meaning that each party will have equal and undivided ownership of the intellectual property. The agreement should clarify whether and to what extent each party has the right to use newly created intellectual property for purposes outside of the strategic alliance. The parties also need to address who will handle patent applications for joint inventions and how the costs for patent applications, prosecutions, and maintenance will be shared. Depending on the resources and objectives of the parties, the authority and expense of prosecuting and maintaining intellectual property protection may be shared by both parties or borne by a designated party. See, *e.g.,* §6.49.

In addition, the parties' agreement should address how the parties will handle intellectual property litigation involving third parties. A claim may be asserted by a third party against the parties related to the intellectual property rights either brought to or developed in the collaboration. Alternatively, one or more of the parties may wish to assert a claim against one or more third parties who may be infringing intellectual property rights relating to the collaboration. See, *e.g.,* §§6.49, 6.85.

Further, the agreement should address the disposition of the intellectual property created by the strategic alliance. Depending on the objectives of the parties, they may agree to assign ownership of the intellectual property rights created to one or more of the parties or to license the intellectual property rights created on agreed terms, often limiting use of the rights to uses that do not compete directly with the strategic alliance or the licensors.

Finally, the parties should consider whether any products resulting from the collaboration will be sold and marketed under a common brand or trademark.

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§6.67 2. Licensing Intellectual Property Rights

Because collaboration agreements generally do not involve the creation of a new legal entity, the agreements generally do not provide for an assignment of intellectual property rights to the collaboration. Instead, the agreements usually provide for licenses or cross-licenses of intellectual property from one party to another. See, *e.g.,* §§6.48, 6.81. All types of intellectual property rights may be licensed, including patents, trademarks, copyrights, software code, trade secrets, and confidential information. The agreement should make clear precisely what intellectual property rights are being licensed or cross-licensed, and the intellectual property rights subject to the license should be clearly described. If the intellectual property rights are registered federally, the agreement should include a detailed schedule that includes registration numbers. See, *e.g.,* §§1.27-1.28.

The agreement should also make clear how the licensed intellectual property is permitted to be used by the licensee and what rights are reserved by the licensor. Often, there are limitations on the scope of the license, such as exclusivity, territory, field of use, or market limitations. Moreover, the licensed rights may themselves constitute licenses from third parties that are limited in scope, and consent of a third party may be required for sublicensing.

Intellectual property rights can be licensed for limited periods or in perpetuity. If the strategic alliance will exist only for a limited period of time or until some objective is achieved, the limitations should be specified in the agreement. If the intellectual property rights are licensed for only a limited period, the agreement may afford the parties the right to extend the term of the license. The right to renew the license may be conditioned on the licensee satisfying certain agreed financial or other performance benchmarks during the initial term of the license.

Consideration for intellectual property licensed to the strategic alliance may take many forms. Consideration may takes the form of a payment by one party to another or a sharing of revenues and expenses resulting from the collaboration. Other forms of consideration are possible, however, such as preferred or exclusive rights to intellectual property developed by the strategic alliance or to discounted or free products or services provided by the strategic alliance.

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§6.68 D. Revenue and Income Sharing

To the extent that the parties will be sharing revenues from the activities undertaken by the collaboration, it is extremely important for the agreement to define precisely what revenue will be subject to division and precisely how the division will be made. Often, the parties divide the net profits from sales of the product or products that result from the collaboration. See the profit-sharing provisions in Article 5 of the sample strategic alliance agreement in §6.82. See also §6.53.

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§6.69 E. Scope of Collaborative Activities

The strategic alliance or collaboration agreement must describe the nature and scope of the collaborative activities and the allocation of responsibilities of the parties to the collaboration. In particular, the agreement should include:

- A detailed description of the activities to be performed;
- A detailed work plan budget, or detailed procedures for establishing budgets, and an allocation of responsibility for the costs and expenses of the collaboration; and
- Provisions for project management and an allocation of responsibility for reporting.

See, *e.g.,* the provisions for joint development and joint commercialization in Articles 2 and 3 of the sample strategic alliance agreement in §§6.79-6.80. See also §6.48. The parties may wish to provide for creation of a separate project plan that describes their respective responsibilities in detail, specifies the personnel from each party who will be dedicated to the project (including each party's project manager), and outlines a preliminary budget for the project.

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§6.70 F. Management and Decision-Making

Most strategic alliance or collaboration agreements provide for the establishment of a joint steering committee by requiring the parties to designate a small group of individuals with overall responsibility to oversee the project and to keep the parties informed regarding its progress. The collaboration agreement should detail who may be a member of the joint steering committee, the scope of its authority, and how disagreements among the members will be resolved, either by the committee as a whole, by escalation to senior management of the parties to the collaboration, or by third parties if appropriate. See, *e.g.,* Articles 2 and 3 of the sample strategic alliance agreement in §§6.79-6.80. See also §§6.48, 6.51.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.71 G. Commercialization

§6.71 G. Commercialization

If the strategic alliance or collaboration is expected to yield a product that can be commercialized, the collaboration agreement must address commercialization and, if applicable, regulatory matters, including:

- Which party will be responsible for handling regulatory matters;
- The distribution rights of each party; and
- Whether there will be an allocation of potential markets for the product.

See, *e.g.,* the provisions for joint commercialization in Article 3 of the sample strategic alliance agreement in §6.80.

If one of the parties will manufacture the product and sell it to the other party, the agreement must address the issues of manufacturing cost and transfer pricing in some detail. If there will be a manufacturing and supply arrangement between the parties once a product is developed, the agreement should include provisions typically found in commercial supply agreements, such as:

- Quantities, forecasts, provisions for firm orders;
- Cancellation procedures;
- Delivery and risk of loss responsibility;
- Testing and quality assurance;
- Product warranties, product recalls;
- Failure or inability to supply, failure to supply conforming products, any other supply failures;
- Possibility of a second source of supply in the event of supply failures; and
- Maintenance of manufacturing records.

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§6.72 H. Representations and Warranties

The representations and warranties made by the parties to the collaboration regarding the intellectual property that each brings to the collaboration are particular important. Strategic alliances formed for the purpose of exploiting intellectual property rights usually depend on a license or contribution of those rights by one or both parties. Each party should assure the other that it has the right to license or transfer those intellectual property rights, that it has good title to the rights, and that the license or other transfer will not infringe or otherwise violate the rights of any other party. The representations and warranties sometimes also include a representation and warranty that the grant of the rights will not require payment of royalty or any other consideration to a third party. Further, the parties sometimes represent and warrant that goods or services covered by the intellectual property rights will perform in accordance with agreed specifications, and, in the case of software, is not "open source" and will be free from harmful viruses and other defects. For sample representations and warranties, see §§6.55, 6.86.

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§6.73 I. Indemnification Against Third Party Claims of Intellectual Property Infringement or Misappropriation

Strategic alliance or collaboration agreements often include indemnification provisions designed to protect one party from third party claims of intellectual property infringement or misappropriation that may be brought against it, based on the intellectual property brought to the collaboration by the other party. Because infringement litigation can be ruinous, the terms of indemnification for intellectual property infringement are often aggressively negotiated and are usually set forth in a separate intellectual property indemnification section, with its own procedures and limitations.

Indemnification for intellectual property infringement or misappropriation reflects the allocation of risks between the collaboration participants. The more limited the terms of the indemnification, the more risk an indemnified party confronts if a claim of infringement or misappropriation is alleged and proved. The parties must therefore evaluate the scope of intellectual property protection of the rights involved and the likelihood that a claim of infringement or misappropriation may arise.

To limit liability, the parties sometimes make the obligation to indemnify conditional on the indemnifying party's right to obtain a license from the prospective plaintiff or to modify the goods or services covered by the intellectual property rights so as not to infringe or misappropriate the intellectual property rights of others. Further, the obligation to indemnify may terminate if the obligation arises from the indemnified party's modification of the goods or services covered by the intellectual property rights without consent of the indemnifying party.

For an example of a clause addressing third party claims of infringement or misappropriation, see §6.85. For examples of intellectual property indemnification provisions, see App F. Other sample indemnification provisions are in §§6.61 and 6.89.

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§6.74 J. Risk of Classification as Partnership

Strategic alliance or collaboration agreements are normally not intended to create a partnership. The parties' intent, however, does not determine whether a partnership has been formed. Under California law, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership." Corp C §16202(a). In general, whether a partnership exists is a question of fact. See *Krantz v BT Visual Images* (2001) 89 CA4th 164, 177, 107 CR2d 209. Accordingly, a disclaimer of partnership status, such as the one contained in section 14.5 (see §6.91) of the sample form of strategic alliance agreement in §§6.78-6.92, does not necessarily resolve the issue. Corporations Code §16202(c) sets forth a series of rules for determining whether a partnership exists. Neither co-ownership of property nor business profit-sharing is conclusive. "The ultimate test of the existence of a partnership is the intention of the parties to carry on a definite business as co-owners. Such intention may be determined from the terms of the parties' agreement or from the surrounding circumstances." *Greene v Brooks* (1965) 235 CA2d 161, 165, 45 CR 99. For further discussion of this issue, see Advising California Partnerships §§13.78A-13.78D (3d ed Cal CEB 1999); 9 Witkin, Summary of California Law: *Partnership* §§24-25 (10th ed 2005).

In negotiating a strategic alliance or collaboration agreement, the parties should consider the risk of potential joint liability and address it through appropriate allocations of costs and expenses, indemnification provisions, insurance, and other risk management techniques.

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§6.75 K. Dispute Resolution

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Strategic alliance or collaboration agreements often contain provisions for alternative dispute resolution. The sample form of strategic alliance agreement in §§6.78-6.92 includes a provision for good faith resolution of the dispute by the chief executive officers of each party and, if that process fails, a provision for binding arbitration under American Arbitration Association rules. See §6.90. An alternative form of arbitration clause, providing for arbitration through the International Institute for Conflict Prevention and Resolution in New York (see http://www.cpradr.org/), is presented in App E. See also the arbitration provision in §6.56.

The World Intellectual Property Organization (WIPO) (http://www.wipo.int) offers an arbitration and mediation service for resolution of international commercial disputes. WIPO's service is recognized as particularly appropriate for technology, entertainment, and other disputes involving intellectual property. There are currently over 1000 WIPO neutrals in countries around the world, including a number in California. Sample contract clauses providing for arbitration or mediation under WIPO procedures are available on WIPO's website. See http://www.wipo.int/amc/en/mediation/contract-clauses/clauses.html#4.

Alternative dispute resolution generally makes sense in a collaboration because the parties typically seek an expeditious means of resolving disputes and preserving the collaborative relationship so that they can continue to recognize the intended benefits of their relationship over time. If the parties are unable to resolve disputes on their own, mediation or arbitration may be very effective as an alternative to litigation.

NOTE: For further discussion of the advantages and disadvantages of alternative dispute resolution and alternative forms of arbitration and mediation clauses, see California Law of Contracts, chap 9 (Cal CEB 2007) and Drafting Business Contracts: Principles, Techniques & Forms, chap 16 (Cal CEB 1994).

If the parties do not wish to subject their disputes to arbitration or mediation, the strategic alliance or collaboration agreement may include a consent to jurisdiction clause such as the following:

***Jurisdiction and Venue*. Each of the Parties irrevocably (i) agree that any suit or other legal proceeding arising out of or relating to this Agreement may be brought only in the Superior Court of the County of Santa Clara, State of California, or in the United States District Court, Northern District of California, San Jose Division; (ii) consents, for itself and in respect of its property, to the jurisdiction of each such court in any such suit or proceeding; and (iii) waives any objection that it may have to the laying of venue of any such suit or proceeding in any of such courts and any claim that any such suit or proceeding has been brought in an inconvenient forum.**

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.76 L. Termination of Collaborative Relationship

§6.76 L. Termination of Collaborative Relationship

Strategic alliances may also afford either or both parties the right to terminate the strategic alliance, either for cause, as a result of an uncured breach of the agreement following notice of, and an opportunity to cure, the breach, or without cause, after expiration of a specified period of time following notice of an intent to terminate. An agreement might provide for a termination fee payable by a party that terminates without cause. The parties may also agree to terminate their agreement based on the occurrence of an external or objective event or merely based on the passage of a certain amount of time. Regardless of the reasons for termination, the agreement should address the consequences of termination with regard to work-in-process and the intellectual property rights licensed or created under the agreement. The agreement may require the apportionment or licensing of intellectual property rights developed by the collaboration and the apportionment of customer contracts and other property, as well as a final accounting of revenues and expenses between the parties. See, *e.g.,* the termination provisions in §6.88. See also §6.58.

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VI. SAMPLE FORM OF STRATEGIC ALLIANCE AGREEMENT

§6.77 A. Introduction

In §§6.78-6.92 is a sample form of strategic alliance or collaboration agreement between two parties seeking to collaborate in the joint development and commercialization of existing and new products, based on access to each other's intellectual property rights. Counsel should note that strategic alliance or collaboration agreements are not standardized, but rather are typically highly negotiated and may vary widely from one collaborative relationship to another. Many provisions in the form below will require modification to reflect the particular situation of each party and its intellectual property, the particular goals of the collaboration, and the specific agreements made by the parties to achieve their goals. Certain provisions of the sample form of joint venture in §§6.46-6.62 may also be applicable to a strategic alliance agreement.

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B. Form: Strategic Alliance Agreement

§6.78 1. Form: Introductory Clause, Recitals, Definitions

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6.78-1 Introductory clause, recitals, definitions

STRATEGIC ALLIANCE AGREEMENT

This Strategic Alliance Agreement (this "Agreement") is entered into as of _ _[*date*]_ _ (the "Effective Date"), between _ _[*name*]_ _, a _ _[*name of state*]_ _ corporation having its principal place of business at _ _[*address*]_ _ ("XYZ"), and _ _[*name*]_ _, a _ _[*name of state*]_ _ corporation having its principal place of business at _ _[*address*]_ _ ("ABC"). XYZ and ABC are referred to in this Agreement collectively as the "Parties" and individually by their respective names or as a "Party."

RECITALS

The Parties desire to collaborate in the joint development and commercialization of ABC Products (as defined in Section 1.4) and Collaboration Products (as defined in Section 1.10).

AGREEMENT

NOW, THEREFORE, the Parties agree as follows:

ARTICLE 1: DEFINITIONS

The following capitalized terms have the following meanings when used in this Agreement:

1.1. "ABC Improvements" means any modification of a Product that, but for the license set forth in Section 4.1, would infringe an ABC Patent.

1.2. "ABC Know-How" means unpublished research and development information, unpatented inventions, know-how, trade secrets, and technical data owned or controlled by ABC on the Effective Date. A list of documents containing ABC Know-How to be transferred to XYZ is attached to this Agreement as Attachment A.

1.3. "ABC Patents" means the Patents listed on Attachment B to this Agreement.

1.4. "ABC Product" means: _ _[*description of product*]_ _.

1.5. "Active Party" has the meaning set forth in Section 6.1.

1.6. "Affiliate" means, with respect to a particular Party, a person, corporation, or other entity that, directly or indirectly, through one or more intermediaries, controls, is controlled by or is under common control with such Party. For purposes of this definition, "control" means the direct or indirect ownership by a Party of at least 50 percent of the outstanding voting securities of the controlled entity; provided, however, that in any country where the law does not permit foreign equity ownership of at least 50 percent, then with respect to corporations organized under such country's laws, "control" shall mean the direct or indirect ownership by a Party of outstanding voting securities of such corporation at the maximum amount permitted by the law of such country.

1.7. "Allowable Expenses" means, with respect to a particular ABC Product or Collaboration Product sold in the Joint Territory, the costs and expenses associated with such Product that the Parties have agreed in either the applicable Development Budget or the applicable Commercialization Budget shall be deducted from Net Revenue for purposes of calculating the Marketing Profits for such Product.

1.8. "Collaboration Discoveries" means any Information that is created, developed, or discovered through a Party's activities under the Research Program. It is agreed that all XYZ Technology and ABC Technology are excluded from the definition of "Collaboration Discoveries."

1.9. "Collaboration Patent" means any Patent or application for a Patent that claims an invention in Collaboration Discoveries, which Patents shall be listed on Attachment C to this Agreement promptly after filing, and ABC shall use reasonable efforts to amend Attachment C from time to time to reflect any changes.

1.10. "Collaboration Product" means any commercial product that comprises or contains, or is developed or manufactured based on or utilizing, or is derived from, the Collaboration Technology or any part thereof, but excluding all ABC Products and XYZ Products.

1.11. "Collaboration Technology" means the Collaboration Discoveries and Collaboration Patents, either collectively or any part thereof.

1.12. "Commercialization Budget" has the meaning set forth in Section 3.5.

1.13. "Commercialization Plan" has the meaning set forth in Section 3.5.

1.14. "Controlled" means, with respect to a particular item, material, or intellectual property right, that a Party owns or has a license under such item, material, or intellectual property right and has the ability to grant to the other Party access to or a license or sublicense under such item, material, or intellectual property right as provided for in this Agreement without violating the terms of any agreement or other arrangement with, or the rights of, any Third Party.

1.15. "Development Budget" has the meaning set forth in Section 2.6.

1.16. "Development Plan" has the meaning set forth in Section 2.6.

1.17. "Field" means _ _[*description of field*]_ _.

1.18. "Inactive Party" has the meaning set forth in Section 6.1.

1.19. "Information" means any and all information and data of any kind, including, without limitation, techniques, inventions, practices, methods, knowledge, know-how, skill, experience, test data, analytical and quality control data, marketing, cost, sales and manufacturing data and descriptions, compositions, and assays.

1.20. "Joint Commercialization Committee" or "JCC" means the committee established by the Parties in accordance with Section 3.3 to manage, direct, and oversee the joint commercialization by the Parties of Collaboration Products and ABC Products in the Joint Territory.

1.21. "Joint Development Committee" or "JDC" means the committee established by the Parties in accordance with Section 2.2 to manage, direct, and oversee the joint development by the Parties of Collaboration Products and ABC Products in the Joint Territory.

1.22. "Joint Territory" means _ _[*description of joint territory*]_ _.

1.23. "Marketing Profit" has the meaning set forth in Section 5.2.3.

1.24. "Net Revenue" means the total revenue received by a Party for sale or other disposition of a Product by such Party or an Affiliate or Sublicensee of such Party to a Third Party, less the following to the extent actually incurred or allowed with respect to such sale or disposition: (a) discounts, including cash discounts, rebates, retroactive price reductions, or allowances actually allowed or granted from the billed amount; (b) credits or allowances actually granted on claims, rejections, or returns of Products, including recalls,

regardless of the Party requesting such; (c) freight, postage, shipping, and insurance charges paid for delivery of Product, to the extent billed; and (d) taxes, duties, or other governmental charges levied on or measured by the billing amount when included in billing, as adjusted for rebates and refunds.

1.25. "Patent" means (a) a valid and enforceable patent, including any extension, registration, confirmation, reissue, re-examination, or renewal thereof; and (b) to the extent valid and enforceable rights are granted by a governmental authority thereunder, a patent application.

1.26. "Patent Costs" means the fees and expenses paid to outside legal counsel and other Third Parties and filing and maintenance expenses, if incurred in connection with the establishment and maintenance of rights under Patents applicable to Products, including the costs of patent interference proceedings.

1.27. "Pre-Reconciliation Profit" shall have the meaning assigned to it in Section 5.2.3.

1.28. "Product" means a Collaboration Product or an ABC Product.

1.29. "Reasonable Efforts" means efforts and resources commonly used in XYZ's and ABC's industry for the research, development, and commercialization of a product at a similar stage in its product life, taking into account the establishment of the product in the marketplace, the competitiveness of the marketplace, the proprietary position of the product, the regulatory structure involved, the profitability of the product, and other relevant factors.

1.30. "Regulatory Approval" means any approvals, licenses, registrations, or authorizations of any federal, state, or local regulatory agency, department, bureau, or other government entity, necessary for the manufacture, use, storage, import, transport, or sale of Products in a regulatory jurisdiction.

1.31. "Sublicensee" means any Third Party expressly licensed by a Party to make and sell one or more Products. A Sublicensee shall not include distributors or sales agents that do no more than purchase and resell finished Products on behalf of a Party.

1.32. "Sublicense Revenues" means all revenues received by either Party from Third Parties from sublicensing of the manufacture, use, and sale of ABC Products or Collaboration Products for sale in the Joint Territory.

1.33. "Third Party" means any entity other than XYZ, ABC, or an Affiliate of XYZ or ABC.

1.34. "Third Party Royalties" means all royalties payable by either of the Parties to Third Parties in respect of the manufacture, use, or sale of ABC Products or Collaboration Products in the Joint Territory.

1.35. "XYZ Improvement" means any modification of a Product that, but for the license set forth in Section 4.2, would infringe an XYZ Patent.

1.36. "XYZ Know-How" means unpublished research and development information, unpatented inventions, know-how, trade secrets, and technical data owned or controlled by XYZ on the Effective Date. A list of documents containing XYZ Know-How to be transferred to ABC is attached to this Agreement as Attachment C.

1.37. "XYZ Patents" means the Patents listed on Attachment D to this Agreement.

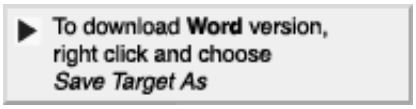
1.38. "XYZ Product" means: _ _[*description of product*]_ _.

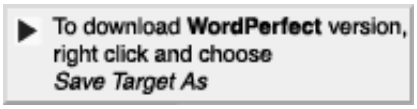
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§6.79 2. Form: Joint Development

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6.79-1 Joint development

ARTICLE 2: JOINT DEVELOPMENT

2.1. *Overview*. XYZ and ABC agree that they will jointly develop ABC Products and Collaboration Products in the Joint Territory in accordance with the terms of this Agreement. All such joint development efforts of the Parties, or of either Party, shall be in accordance with the Development Plan for each ABC Product or Collaboration Product. Except as otherwise provided in this Agreement, each Party agrees that neither Party may develop an ABC Product or Collaboration Product for sale or distribution in the Joint Territory, or license any Third Party to do so, except jointly with the other Party under this Agreement. However, as provided further in Article 6, it is agreed that, if one Party determines that it does not wish to proceed with such joint development of a particular Product, the other Party shall be permitted to do so on its own in accordance with Article 6.

2.2. *Joint Development Committee*. The Parties shall form a Joint Development Committee for the development of an ABC Product or Collaboration Product, comprised of 6 members, with 3 members to be appointed and replaced by XYZ and 3 members to be appointed and replaced by ABC. The Parties may subsequently agree to change the size of the JDC, as appropriate to meet the needs of the Parties in managing their joint efforts under this Agreement. The JDC shall (a) prepare the Development Plan for the ABC Product or Collaboration Product, and modify or amend it as appropriate during the development process, based on the results of the development efforts on such product; and (b) perform such other duties and obligations as the Parties specifically delegate to it in writing by mutual written agreement of the Parties.

2.3. *JDC Meetings*. JDC meetings shall take place at such mutually convenient times and places as determined by the JDC, with the expectation that meetings will alternate between appropriate offices of each Party. The JDC shall determine the frequency of its meetings and how such meetings will be conducted and recorded.

2.4. *Decision-Making and Issue Resolution*. All decisions of the Joint Development Committee shall be unanimous by the members of such committee. If the JDC fails to reach unanimous agreement on an issue needing resolution, the matter shall be referred for good faith discussion and resolution by a senior executive officer designated by each Party for that purpose.

2.5. *Joint Development*. For each Product selected by the Parties by mutual written agreement for joint development under this Agreement, XYZ and ABC agree that they will jointly conduct, or have conducted, all development work in the Joint Territory on such Product in accordance with the Development Plan developed by the JMC for such Product. Each Party agrees not to incur any expenses or costs in excess of the Development Budget within the Development Plan except as the Parties mutually agree in writing.

2.6. *Development Plans and Development Budgets*. Promptly after the selection of a particular Product for development by the Parties, the JDC shall prepare and provide to each Party for final approval a development plan for such Product in the Joint Territory (the "Development Plan"). The Development Plan shall include all needed details regarding the development and other work to be undertaken to develop such Product in the Joint Territory, including an allocation of all such work as appropriate to each Party (or to selected Third Party contractors, as agreed), and shall establish a budget (the "Development Budget") for all costs and expenses to be incurred by each Party in conducting the work allocated to it under such Development Plan. Each Party shall diligently review the proposed Development Plan and shall either approve the plan or provide the JDC with any requested changes and comments. If a Party provides requested changes or comments to a proposed

Development Plan, the JDC shall promptly thereafter prepare a revised draft of the Development Plan, accommodating those changes and comments, and resubmit the revised Development Plan for approval by the Parties as provided above. Once the Parties have agreed on the Development Plan proposed by the JDC, the Development Plan shall be effective and shall control and govern the Parties' development effort in the Joint Territory with respect to the applicable Product, subject to any subsequent amendments or modifications to such Development Plan as provided below. From time to time during the development of such Product, the JDC shall review the Development Plan in light of the results of the development work and any other relevant Information and shall amend or modify the Development Plan as appropriate, provided that the JDC may not increase the applicable Development Budget without the written approval of each Party. At least 60 days prior to January 1 of any year in which the Parties are developing a particular Product under this Agreement, the JDC shall review the applicable Development Budget for such Product and shall submit a revised and updated Development Budget for the coming calendar year to each of the Parties for approval as provided above. On such approval, the Development Budget shall be effective for the development of such Product in the Joint Territory during such calendar year, subject to further amendment of the applicable Development Plan.

2.7. *Costs of Joint Development*. All Development Costs incurred or expended by a Party in conducting the joint development work on a Product under this Agreement and allocated to it under the applicable Development Plan shall initially be borne by the Party incurring such costs and expenses, subject to reimbursement as provided in this Section and in Section 2.8. Each Party shall calculate and maintain records of all the Development Costs incurred or expended by it during its performance of development on a Product, in accordance with generally accepted accounting procedures consistently applied throughout such Party's organization and any other procedures agreed on by the Parties. Each Party shall report quarterly to the other on the Development Costs that it has incurred in each calendar quarter, on a Product-by-Product basis, and the purpose (referencing the activities within the applicable Development Plan) for which such costs were incurred or expended, with such reports to be submitted within 60 days after the end of each of the first 3 calendar quarters and 90 days after the end of the calendar year. The Parties shall seek to resolve promptly and in good faith any questions or issues related to such accounting statements, and in any event within 90 days following receipt.

2.8. *Reimbursement of Development Costs*.

2.8.1. For each particular calendar quarter during which Development Costs are incurred under this Agreement, each Party shall review the Development Costs report submitted by the other Party and compare such submission to the applicable Development Budgets. The Parties shall then meet, through designated senior officers from each Party with financial accounting responsibility, to discuss the reports and reach agreement on the total amount of Development Costs that each Party may properly apply to the joint development work under this Agreement. It is understood and agreed that a Party will not be entitled to obtain credit or reimbursement for any Development Costs incurred by the Party in excess of the amount set forth in the applicable Development Budget for accomplishing the relevant task or objective. If such officers cannot reach agreement promptly, the matter shall be submitted to senior executive officers of each Party for prompt resolution, with the understanding that each Party shall provide access to any Information relating to the development work undertaken by that Party and the calculation of actual costs and expenses incurred for such work, with respect to Products during the calendar quarter for which that Party seeks reimbursement or credit under this Agreement for the related Development Costs.

2.8.2. Once the Parties have agreed on the total amount of Development Costs incurred or expended during a particular calendar quarter that are creditable or reimbursable by the Parties as provided in Section 2.8.1, the total shall be divided in half and the result shall be compared to the total agreed reimbursable Development Costs incurred by each Party during that quarter. The Party that bore less than its one-half share of the total costs shall reimburse the other Party for the difference, in cash or other immediately available funds, within 60 days of such determination.

2.9. *Audit Rights*. Each Party shall have the right to have an independent accounting firm audit the other Party's relevant records to determine the accuracy of the Development Costs reported by the other Party under Section 2.7 above. Such audit right shall be exercised following comparable procedures to those set forth in Section 10.2 below.

2.10. *Manufacture and Supply*. The Parties shall agree in good faith on commercially reasonable terms for the manufacture and supply of supplies of Collaboration Products and ABC Products in the Joint Territory on a Product-by-Product basis.

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§6.80 3. Form: Joint Commercialization

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6.80-1 Joint commercialization

ARTICLE 3: JOINT COMMERCIALIZATION

3.1. *Overview*. XYZ and ABC agree that they will jointly commercialize ABC Products and Collaboration Products in the Joint Territory in accordance with the terms of this Agreement; provided, however, that if the Parties cannot agree on whether a particular Product should be commercialized in the Joint Territory, the Party who wishes to commercialize that Product may do so in accordance with Article 6. All such joint commercialization efforts of the Parties, or either Party, shall be consistent with the applicable Commercialization Plan for each ABC Product or Collaboration Product. Except as otherwise provided in this Agreement, each Party agrees that neither Party may develop an ABC Product or Collaboration Product for sale or distribution in the Joint Territory, or license any Third Party to do so, except jointly with the other Party under this Agreement.

3.2. *Joint Commercialization Committee*. Promptly after the Effective Date, the Parties shall form the Joint Commercialization Committee, comprised of 6 members, with 3 members being appointed and replaced by XYZ and 3 members being appointed and replaced by ABC. The Parties may subsequently agree to change the size of the JCC, as appropriate to meet the needs of the Parties in managing the joint efforts under this Agreement. The JCC shall (a) prepare the Commercialization Plan for each ABC Product or Collaboration Product, and modify or amend it as appropriate, based on the results of the commercialization efforts on such product, during the development process; and (b) perform such other duties and obligations as the Parties specifically delegate to it in writing by mutual written agreement.

3.3. *JCC Meetings*. JCC meetings shall take place at such mutually convenient times and places as determined by the JCC, with the expectation that meetings will alternate between appropriate offices of each Party. The JCC shall determine the frequency of its meetings and how such meetings will be conducted and recorded.

3.4. *Decision-Making and Issue Resolution*. All decisions of the Joint Commercialization Committee shall be unanimous by the members of such committee. If the JCC fails to reach unanimous agreement on an issue needing resolution, the matter shall be referred for good faith discussion and resolution by a senior executive officer delegated by each Party for such purpose.

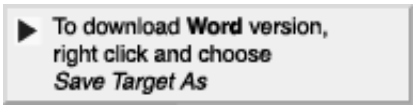
3.5. *Commercialization Program*. The Joint Commercialization Committee shall develop and maintain a detailed commercialization plan for each Product, setting forth all the programs and actions to be taken for the commercialization of that Product in the Joint Territory (the "Commercialization Plan"). The initial Commercialization Plan for a Product shall be prepared, reviewed, and approved as soon as practicable after the JCC determines that the Product is sufficiently likely to achieve Regulatory Approval in the Joint Territory to justify commencing pre-launch activities for such Product in the Joint Territory. Each Commercialization Plan shall include at a minimum the following Information: (a) a comprehensive marketing, sales, pricing, manufacturing, distribution, and licensing strategy for the applicable Product in the Joint Territory, including the tasks assigned to each Party to conduct such marketing, promotion, and sales, and any proposed arrangements with Third Parties to be utilized or proposed to be agreed on; (b) market forecasts, in units of product and local currency, and competitive analysis for the applicable Product in the Joint Territory; and (c) a budget for the Allowable Expenses that each Party may incur in the marketing and sales efforts for the Product assigned to that Party under the Commercialization Plan (the "Commercialization Budget"). The Commercialization Plan shall be submitted to XYZ and ABC for approval and shall be updated and approved on an annual basis, no later than 60 days before the end of each calendar year.

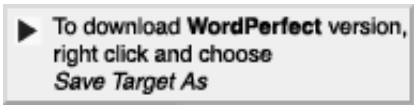
3.6. *Sublicensees.* In territories within the Joint Territory where one Party has been assigned under the applicable Commercialization Plan the sole responsibility for commercializing a Product, that Party may sublicense to one or more Third Parties any or all of its commercialization activities with respect to such Product. In all territories within the Joint Territory where the commercialization efforts for a Product are allocated to both Parties under the applicable Commercialization Plan, a Party shall have the right to sublicense or contract with Third Parties to perform the commercialization efforts assigned to that Party only with the prior written approval of the other Party, such approval not to be unreasonably withheld or delayed. All amounts received by the Parties for sublicensing any rights to develop or commercialize any Product in the Joint Territory shall be deemed to be Sublicense Revenues.

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§6.81 4. Form: Rights and Licenses

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6.81-1 Rights and licenses

ARTICLE 4: RIGHTS AND LICENSES

4.1. *Commercial License to XYZ.* Subject to the terms of this Agreement, ABC hereby grants to XYZ a sole and co-exclusive license (*i.e.,* exclusive as to all parties except ABC), with the right to grant sublicenses under the ABC Technology and the Collaboration Technology solely to develop, make, have made, use, sell, offer for sale, and import ABC Products and Collaboration Products in the Joint Territory as permitted under this Agreement.

4.2. *Commercial License to ABC*. Subject to the terms of this Agreement, XYZ hereby grants to ABC a sole and co-exclusive license (*i.e.,* exclusive as to all parties except XYZ), with the right to grant sublicenses under the XYZ Technology solely to develop, make, have made, use, sell, offer for sale, and import ABC Products in the Joint Territory as permitted under this Agreement.

4.3. *License Limitations and Covenants*. Each Party agrees that it shall not use or practice the intellectual property rights of the other Party licensed under this Agreement except as expressly permitted by this Agreement. Except for the rights specifically granted in this Agreement, each Party expressly reserves all rights Controlled by it or its Affiliates to all products and intellectual property rights, and reserves the right to utilize or allow Third Parties to utilize such products and intellectual property rights in any manner consistent with the terms of this Agreement.

[*If applicable, add the following*]

4.4. *Restrictions on Sale.* ABC and its Affiliates shall not resell _ _[*description of product part*]_ _ purchased under this Agreement except as part of an ABC Product or a Collaboration Product, and shall not use _ _[*description of product part*]_ _ for any purpose other than those purposes permitted in this Agreement. XYZ shall retain all rights to manufacture or have manufactured the _ _[*description of product part*]_ _.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.82 5. Form: Profit-Sharing

§6.82 5. Form: Profit-Sharing

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6.82-1 Profit-sharing

ARTICLE 5: PROFIT-SHARING

5.1. *Share of Marketing Profits*. During the term of this Agreement, XYZ and ABC each shall be entitled to receive and retain 50 percent of the Marketing Profits realized from the sale or other commercialization of ABC Products and Collaboration Products in the Joint Territory, as calculated in Section 5.2.

5.2. *Calculation of Marketing Profits*.

5.2.1. All Allowable Expenses incurred or expended by a Party under this Agreement in conducting the commercialization work for a Product in accordance with the applicable Commercialization Plan shall initially be borne by the Party incurring such costs and expenses, subject to reimbursement as provided in this Article 5. Each Party shall calculate and maintain records of all the Allowable Expenses incurred or expended by it during its performance of commercialization efforts on a Product and of all Net Revenues and Sublicense Revenues received by it under this Agreement, in accordance with generally accepted accounting procedures consistently applied throughout such Party's organization and any other procedures agreed on by the Parties. Each Party shall report quarterly to the other Party on the Allowable Expenses that it has incurred or expended in each calendar quarter and all Net Revenues and Sublicense Revenues received by it in such quarter, on a Product-by-Product basis, and the purpose (referencing the activities within the applicable Commercialization Plan) for which such costs were incurred or expended, with such reports to be submitted within 60 days after the end of each of the first 3 calendar quarters and 90 days after the end of the calendar year. The Parties shall seek to resolve promptly and in good faith any questions or issues related to such accounting statements, and in any event within 90 days following receipt.

5.2.2. For each calendar quarter in which Allowable Expenses are incurred under this Agreement, each Party shall review the Allowable Expenses report submitted by the other Party and compare such submission to the Commercialization Plan for the applicable Product. The Parties will then meet, through designated senior officers from each Party with financial accounting responsibility, to discuss the reports and reach agreement on the total amount of Allowable Expenses that each Party may properly apply to the calculation of Marketing Profit. If such officers cannot reach agreement promptly, the matter shall be submitted to senior executive officers of each Party for prompt resolution, with the understanding that each Party shall provide access to any Information relating to the commercialization work undertaken by it and its calculation of actual costs and expenses incurred for such work with respect to Products during such calendar quarter for which it seeks reimbursement or credit.

5.2.3. Once the Parties have agreed on the total amount of Allowable Expenses incurred or expended in a particular calendar quarter that are creditable or reimbursable by the Parties as provided in Section 5.2.2, that amount shall be subtracted from the total Net Revenues and Sublicense Revenues received by both Parties for all applicable Products during such quarter, and the remainder shall be deemed the total "Marketing Profit" for such quarter. In addition, the Parties shall determine the profit of each Party, before reconciliation as set forth in Section 5.3, by subtracting the amount of Allowable Expenses incurred or expended by such Party in a particular calendar quarter that are creditable or reimbursable by the Parties as provided in Section 5.2.2 from the total Net Revenues and Sublicense Revenues for all applicable Products during such quarter that were collected and retained by such Party, and the remainder shall be deemed such Party's "Pre-Reconciliation Profit" for such quarter.

5.2.4. For the calculation of Marketing Profits and Pre-Reconciliation Profits under this Agreement for

a particular quarter, all amounts of Allowable Expenses incurred or expenses in such quarter in currencies other than U.S. Dollars, and all amounts of Net Revenues and Sublicense Fees received in currencies other than U.S. Dollars, shall be converted to the U.S. Dollar equivalent for purposes of making such calculations, with such conversion effected by using the currency exchange rate into U.S. Dollars as quoted in the Wall Street Journal on the last business day of that quarter.

5.3. *Reconciliation Payments*. To the extent that one Party's Pre-Reconciliation Profit (as calculated in Section 5.2.3) for a particular quarter exceeds one-half of the Marketing Profit for that quarter, that Party shall pay the amount (in U.S. Dollars) of the excess to the other Party within 30 days after the Parties have determined such amounts, so that each Party retains one-half of the Marketing Profit for such quarter, after calculating all Allowable Expenses and Net Revenues for such quarter.

5.4. *Term of Profit-Sharing*. The Parties' obligation to share Marketing Profits under this Agreement shall expire with respect to a particular Product being sold or otherwise commercialized in a country of the Joint Territory on the later to occur of: (a) the expiration of the last to expire of the Collaboration Patents, XYZ Patents, or ABC Patents covering that Product in that country, or (b) the date on which that Product ceases to be promoted, marketed, or sold in that country under the trademark for it designated by the Parties under the applicable Development Plan or Commercialization Plan. On the expiration of the sharing obligation described above, each Party shall have the right to commercialize that Product in that country without obligation to the other Party, and the license rights granted in Article 4 with respect to that Product in that country shall be automatically deemed to be nonexclusive, fully paid, perpetual, and irrevocable licenses for that Product in that country.

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§6.83 6. Form: Single Party Development and Commercialization

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6.83-1 Single party development and commercialization

ARTICLE 6: SINGLE PARTY DEVELOPMENT AND COMMERCIALIZATION

6.1. *Single Party Development and Commercialization*. Subject to the terms of this Article 6, if the Parties cannot agree on whether to develop or commercialize a particular Product in the Joint Territory under Section 2.1 or Section 3.1, or if a Party decides to terminate its development activities or commercialization activities with regard to a particular Product under Section 11.2, the Party that wants to proceed with or continue such development or commercialization (the "Active Party") may do so at its discretion, without the financial support or involvement of the other Party (the "Inactive Party"). If a Party becomes an Inactive Party, the Active Party shall have a perpetual, royalty-free right to use any data jointly obtained by the Parties relating to the Product or Products for which the other Party became an Inactive Party, to develop and commercialize those Products in the Joint Territory.

6.2. *Royalties*. The Active Party shall pay the Inactive Party a royalty on the sales of Products as follows:

6.2.1. For ABC Products

6.2.1.1 If XYZ is the Active Party, a royalty equal to _ _[*number*]_ _ percent of the Net Revenue based on sales of the ABC Product sold by XYZ, its Affiliates, or any of its Sublicensees in the Joint Territory; or

6.2.1.2. If ABC is the Active Party, a royalty equal to _ _[*number*]_ _ percent of the Net Revenue based on sales of the ABC Product sold by ABC, its Affiliates, or any of its Sublicensees in the Joint Territory.

6.2.2. For Collaboration Products

6.2.2.1. If XYZ is the Active Party, a royalty equal to _ _[*number*]_ _ percent of the Net Revenue based on sales of the Collaboration Product sold by XYZ, its Affiliates, or any of its Sublicensees in the Joint Territory; or

6.2.2.2. If ABC is the Active Party, a royalty equal to _ _[*number*]_ _ percent of the Net Revenue based on sales of the Collaboration Product sold by ABC, its Affiliates, or any of its Sublicensees in the Joint Territory.

6.3. *Recovery of Investments*. If a Party becomes the Inactive Party pursuant to Section 11.2, the Active Party shall pay the Inactive Party, in addition to the royalties set forth in Section 6.2, a royalty equal to _ _[*number*]_ _ percent of the Net Revenue based on sales of the applicable Product sold by the Active Party, its Affiliates, or any of its Sublicensees in the Joint Territory, until such time as the sum of the royalties paid to the Inactive Party under this Section 6.3 is equal to the sum of any costs and expenses made by the Inactive Party in accordance with the applicable Development Budget or Commercialization Budget for the applicable Product prior to that Party's inactivity.

6.4. *Royalty Reduction*.

6.4.1. If ABC or XYZ, as applicable, sells a particular Collaboration Product in a country where, at the time of sale, there is no issued Collaboration Patent that claims such Collaboration Product or its manufacture or use, then the amount of royalty owed by such Party to the other Party under Section 6.2 shall be reduced by

_ _[*number*]_ _ percent with respect to the sale.

6.4.2. If ABC or XYZ, as applicable, sells an ABC Product in a country where, at the time of sale, there is no issued XYZ Patent or ABC Patent that claims such ABC Product or its manufacture or use, then the amount of royalty owed by such Party to the other Party under Section 6.2 shall be reduced by _ _[*number*]_ _ percent with respect to the sale.

6.5. *Payment of Royalties*. Royalties under this Article 6 shall accrue on the sale of the particular Collaboration Product or ABC Product (deemed to occur on the earlier of transfer of title or invoice date), and royalties that have accrued during a particular calendar quarter shall be paid by the Party owing such royalties within 60 days after the end of that calendar quarter.

6.6. *Manner of Payment*. Remittance of payments under this Article 6 shall be made by means of wire or electronic transfer to the receiving Party's account in a bank to be designated by such Party in writing.

6.7. *Reports*. All amounts payable under this Agreement shall be accompanied by a report listing the gross selling price of each Collaboration Product or ABC Product sold during the applicable calendar quarter on a Product-by-Product and country-by-country basis, and the calculation of Net Revenue based on such sales, including all other information necessary to determine the appropriate amount of royalty payments, and any additional information or reports required under the Agreement.

6.8. *Withholding of Taxes*. All turnover, income, and other taxes levied on account of the royalties accruing or made to a Party under this Article 6 shall be paid by that Party. If withholding of taxes of any type, levies, or other charges is required by applicable law or regulation with respect to any royalty payable under this Article 6, then the paying Party shall be entitled to deduct such tax, levy, or charge from the royalty or other payment to be made and pay such tax, levy, or charge to the proper taxing authority. A receipt for payment of the tax, levy, or charge shall be promptly delivered to the other Party, together with copies of all communications to or from such Governmental Authorities with respect thereto. The paying Party agrees to cooperate with the other Party in any effort to claim an exemption from such deductions or withholdings under any double taxation or similar agreement or treaty from time to time in force and in minimizing the amount required to be so withheld or deducted, such cooperation to consist of providing to the other Party receipts for payment of such withheld tax and any other pertinent documents reasonably available to the paying Party.

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§6.84 7. Form: Confidentiality

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6.84-1 Confidentiality

ARTICLE 7: CONFIDENTIALITY

7.1. *Confidentiality; Exceptions*. Except to the extent expressly authorized by this Agreement or otherwise agreed in writing, the Parties agree that, for the term of this Agreement and for 10 years thereafter, the receiving Party shall keep confidential and shall not publish or otherwise disclose or use for any purpose other than as provided in this Agreement any Information or other information and materials furnished to it by the other Party under this Agreement (collectively, "Confidential Information"); provided, however, that the foregoing obligations of non-use and nondisclosure shall not apply to any Information or materials to the extent that the receiving Party can establish by competent proof that such Information or materials:

7.1.1. Was already known to the receiving Party, other than under an obligation of confidentiality, at the time of disclosure by the other Party;

7.1.2. Was generally available to the public or otherwise part of the public domain at the time of its disclosure to the receiving Party;

7.1.3. Became generally available to the public or otherwise part of the public domain after its disclosure and other than through any act or omission of the receiving Party in breach of this Agreement; or

7.1.4. Was disclosed to the receiving Party, other than under an obligation of confidentiality, by a Third Party who had no obligation to the disclosing Party not to disclose such information to others.

7.2. *Authorized Disclosure*. Each Party may disclose the other's Confidential Information to the extent such disclosure is reasonably necessary in filing or prosecuting patent applications, prosecuting or defending litigation, or complying with applicable governmental regulations, provided that if a Party is required by law or regulation to make any such disclosure of the other Party's Confidential Information, it shall, except to the extent impracticable for certain necessary disclosures (*e.g.*, in the event of medical emergency), give reasonable advance notice to the other Party of such disclosure requirement, and, except to the extent inappropriate in the case of patent applications, it shall use commercially reasonable efforts to secure confidential treatment of such Confidential Information required to be disclosed.

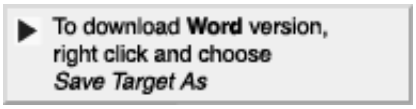
7.3. *Survival*. This Article 7 shall survive the termination or expiration of this Agreement for a period of 5 years.

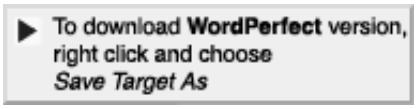
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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.85 8. Form: Intellectual Property

§6.85 8. Form: Intellectual Property

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6.85-1 Intellectual property

ARTICLE 8: INTELLECTUAL PROPERTY

8.1. *Ownership*. Unless expressly granted in this Agreement, no licenses or rights under either Party's intellectual property rights are implied or granted in this Agreement. Each Party shall retain full ownership of all its inventions and intellectual property.

8.2. *Patent Infringement in the Joint Territory*. If either Party believes that a Third Party is infringing an ABC Patent, XYZ Patent, or Collaboration Patent in the Joint Territory in which an ABC Product or Collaboration Product is being developed, marketed, or sold, that Party shall give the other Party prompt notice of its belief and all Information supporting its belief. The Parties shall use good faith efforts to coordinate and cooperate in any action, negotiation, or settlement of the alleged infringement. The costs of any such action, negotiation, or settlement shall be deemed to be Allowable Expenses of the Parties, and all amounts recovered from the Third Party infringer based on such action, negotiation, or settlement shall be deemed to be "Sublicense Fees" received in the calendar quarter in which the amounts are paid.

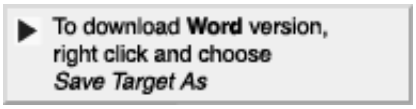
8.3. *Defense and Settlement of Third Party Claims in the Joint Territory*. If a Third Party makes a claim or allegation against a Party (or both Parties) that a Patent, trademark, trade secret, or other intangible right owned or licensed by the Third Party is infringed or misappropriated by the manufacture, use, or sale of any Collaboration Product or ABC Product in the Joint Territory, the Parties shall immediately meet to discuss the matter and shall establish a plan for a common defense of such claim or allegation. The Parties shall cooperate and provide each other all reasonable assistance in defending against any such claim, provided that each Party shall have the right to defend itself. The costs and expenses of each Party in defending against any such action (including without limitation the amount of any judgment, award, decree, or settlement actually paid to such Third Party by a Party) shall be deemed to be Allowable Expenses of the Party paying such amounts in the calendar quarter paid, to the extent that such costs and expenses relate directly to defense or settlement of claims or allegations concerning Products made, used, or sold in the Joint Territory under this Agreement. If there is an opportunity to settle or otherwise resolve any such infringement or misappropriation claim or allegation by taking a license from the Third Party, the Party that becomes aware of such opportunity shall immediately discuss such opportunity with the other Party, and the Parties shall discuss in good faith whether and how to negotiate and enter into a license with the Third Party. It is understood and agreed that a Party, in negotiating and entering into any such license, may not negotiate terms for such a license that cover rights outside the Joint Territory unless such terms do not differentiate between Products in the Joint Territory and products sold by such Party outside the Joint Territory in a manner that may be unfair to the other Party. If any such Third Party license is taken, all amounts paid to the Third Party under the license, to the extent directly relating to or allocable to the manufacture, use, or sale of Products in the Joint Territory under this Agreement, shall be deemed to be Allowable Expenses of the Party making such payments, in the calendar quarter such payments are made.

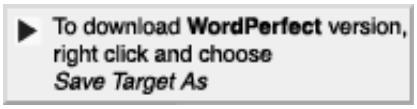
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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.86 9. Form: Intellectual Property

§6.86 9. Form: Intellectual Property

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6.86-1 Intellectual property

ARTICLE 9: REPRESENTATIONS AND WARRANTIES

Each Party represents and warrants to the other Party as follows:

9.1. This Agreement is its legal, valid, and binding obligation, enforceable against it in accordance with the terms of this Agreement.

9.2. Its execution, delivery, and performance of this Agreement does not conflict with any agreement, instrument, or understanding, oral or written, to which it is a party or by which it is bound, nor violate any law or regulation of any court, governmental body, or administrative or other agency having jurisdiction over it.

9.3. It has not granted any right to any Third Party relating to its intellectual property rights licensed by it under this Agreement in the Field that would conflict with the rights granted to the other Party under this Agreement.

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Source: Business Law/Intellectual Property in Business Transactions/6 Joint Ventures and Strategic Alliances/§6.87 10. Form: Reports, Records, and Samples

§6.87 10. Form: Reports, Records, and Samples

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6.87-1 Reports, records, and samples

ARTICLE 10: REPORTS, RECORDS, AND SAMPLES

10.1. *Sharing of Information*. XYZ and ABC shall make available and disclose to each other all Information known by them concerning the development and commercialization of ABC Products and Collaboration Products in the Joint Territory during the term of this Agreement. The Parties shall exchange at least monthly verbal or written reports in English presenting a meaningful summary of the development and commercialization done under this Agreement. Each Party shall make regular presentations to the other of its activities under this Agreement, other than within the Joint Management Committee (or any applicable subcommittee), and additionally on an informal basis, to inform the other Party of the work done under this Agreement.

10.2. *Records and Audit*. For a period of 3 years after the royalty period to which the records relate, each Party shall keep complete and accurate records pertaining to the sale or other disposition of the Collaboration Products or ABC Products commercialized by it, in sufficient detail to permit the other Party to confirm the accuracy of all payments due under this Agreement. A Party entitled to payments under this Agreement shall have the right to cause an independent certified public accountant reasonably acceptable to the other Party (and who has executed a confidentiality agreement with the Party to be audited) to audit such records to confirm the Net Revenue, Sublicense Fees, Allowable Expenses, and royalty payments; provided, however, that the auditor shall not disclose the audited Party's confidential information to the other Party, except to the extent that disclosure is necessary to verify the amount of royalties and other payments due under this Agreement. In no event shall the auditor disclose the names of the audited Party's specific customers, price lists, or the prices charged to specific customers. A copy of any report provided by the auditor shall be provided to the audited Party at the time that the report is provided to the auditing Party. Such audit right may be exercised once a year, within 3 years after the royalty or other payment period to which such records relate, on a mutually acceptable date or dates and on not less than 30 days' advance notice, and shall be conducted during normal business hours. Any amounts shown to be owing by such audits shall be paid immediately with interest in the amount of 1 percent per month (or the maximum amount permitted by law, if less) from the date first owed until paid. The auditing Party shall bear the full cost of the audit unless the audit discloses that royalties actually paid by the audited Party are more than 5 percent less than the amount of royalties or other payments actually owed. In such case, the audited Party shall bear the full cost of the audit. The terms of this Section 10.2 shall survive any termination or expiration of this Agreement for a period of 2 years.

10.3. *Materials*. The Parties intend to maintain an open and extensive exchange of research materials that relate to ABC Products and Collaboration Products being developed or commercialized in the Joint Territory during the course of the collaboration under this Agreement. Information obtained by a Party in testing such research materials shall be promptly disclosed to the Party providing the sample, and all such Information shall be considered Information to be protected by both Parties under the restrictions of Article 7. ANY MATERIALS EXCHANGED BETWEEN THE PARTIES ARE FURNISHED WITH NO WARRANTIES OF ANY KIND, EXPRESS OR IMPLIED, INCLUDING ANY WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR ANY WARRANTY THAT THE MATERIALS ARE FREE FROM THE RIGHTFUL CLAIM OF ANY THIRD PARTY, BY WAY OF INFRINGEMENT OR THE LIKE. NEITHER PARTY MAKES ANY REPRESENTATIONS THAT THE USE OF THE MATERIALS WILL NOT INFRINGE ANY PATENT OR PROPRIETARY RIGHTS OF ANY THIRD PARTY.

10.4. *Publicity Review*. If either Party is required by law or regulation to make a public disclosure or announcement concerning any activities conducted under or arising out of this Agreement or the subject matter of this Agreement, that Party shall give reasonable prior advance notice of the proposed text of such

disclosure or announcement to the other Party for its review and comment. The terms of this Agreement may also be disclosed to: (a) Third Parties with the consent of the other Party, which consent shall not be unreasonably withheld so long as such disclosure is made under a binder of confidentiality, and (b) investors, potential investors, underwriters, and potential underwriters of XYZ, so long as such disclosure is made under a binder of confidentiality.

10.5. *Publications*. Each Party agrees that it shall not publish or present the results of studies carried out as part of the development of any ABC Product or Collaboration Product under this Agreement without the opportunity for prior review by the other Party. Each Party shall provide to the other the opportunity to review any proposed abstracts, manuscripts, or presentations (including information to be presented verbally) that relate to the Field at least 30 days before their intended submission for publication, and the submitting Party agrees, on written request from the other Party, not to submit such abstract or manuscript for publication or to make such presentation until the other Party is given a reasonable period of time to secure patent protection for any material in such publication or presentation that the other Party believes is patentable.

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§6.88 11. Form: Term and Termination

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6.88-1 Term and termination

ARTICLE 11: TERM AND TERMINATION

11.1. *Term.* This Agreement shall commence on the Effective Date and, unless sooner terminated as provided in this Agreement, shall continue in effect until the later of (a) the expiration of the last to expire of the ABC Patents, XYZ Patents, or Collaboration Patents in the Joint Territory that claim ABC Products or Collaboration Products, or (b) the date on which the Parties are no longer obligated to share Marketing Profits for any ABC Product or Collaboration Product under Article 5 or to pay royalties under Article 6.

11.2. *Termination of Joint Development or Joint Commercialization*. On 90 days' prior written notice to the other Party, a Party may terminate, in its sole discretion, its development or commercialization obligations, or both, with regard to a particular Product. On any such termination, the provisions of Article 6 shall apply, and the Active Party shall have no further obligations to the Inactive Party with regard to such Product, except as set forth in Article 6.

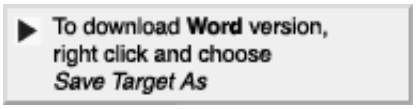
11.3. *Termination for Breach*. If either Party materially breaches this Agreement and such breach is not cured within 60 days after the date of transmittal of a written notice of the breach from the nonbreaching Party, the breaching Party's licenses granted in this Agreement shall terminate and the nonbreaching Party shall retain an exclusive, royalty-free right under the XYZ Technology, ABC Technology, and Collaboration Technology to make, have made, use, and sell ABC Products and Collaboration Products developed or sold in the Joint Territory before breach of the Agreement. The breaching Party shall assist the nonbreaching Party in every proper way to effect the license granted above. The breaching Party shall further deliver to the nonbreaching Party such relevant tangible materials embodying such XYZ Technology, ABC Technology, and Collaboration Technology as may be necessary or useful to the exercise of the nonbreaching Party's rights under this Section 11.3.

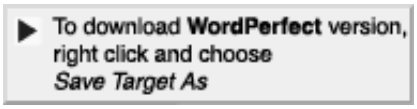
11.4. *Surviving Rights.* The obligations and rights of the Parties under Articles 7, 8, and 12, Section 10.2, and _ _[*designate other sections that survive*]_ _ of this Agreement shall survive termination of this Agreement for the periods designated in those provisions, or if no period is designated, a period of _ _[*designate survival period*]_ _.

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§6.89 12. Form: Indemnification

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6.89-1 Indemnification

ARTICLE 12: INDEMNIFICATION

12.1. *Indemnification by ABC*. ABC shall indemnify, defend, and hold XYZ harmless from and against any and all liability, damage, loss, cost (including reasonable attorney fees), and expense resulting from any claim of bodily injury or property damage (a) relating to the development, manufacture, use, distribution, or sale of any ABC Product or Collaboration Product by ABC, its Affiliates, Sublicensees, employees, or agents in the Joint Territory, or (b) due to the negligence or willful misconduct of ABC or its Affiliates, Sublicensees, employees, or agents.

12.2. *Indemnification by XYZ*. XYZ shall indemnify, defend, and hold ABC harmless from and against any and all liability, damage, loss, cost (including reasonable attorney fees), and expense resulting from any claim of bodily injury or property damage (a) relating to the development, manufacture, use, distribution, or sale of any ABC Product or Collaboration Product by XYZ, its Affiliates, Sublicensees, employees, or agents in the Joint Territory, or (b) due to the negligence or willful misconduct of XYZ or its Affiliates, Sublicensees, employees, or agents.

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§6.90 13. Form: Alternative Dispute Resolution

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6.90-1 Alternative dispute resolution

ARTICLE 13: ALTERNATIVE DISPUTE RESOLUTION

13.1. *Good Faith Negotiations.* The Parties recognize that a bona fide dispute regarding certain matters may from time to time arise during the term of this Agreement that relates to the rights or obligations of either Party under this Agreement. In the event of the occurrence of such a dispute, either Party may, by notice to the other Party, have such dispute referred to their respective designees listed below or the successors of their respective designees for attempted resolution by good faith negotiations within 60 days after such notice is received. Each Party's designee is as follows:

For Company A: Chief Executive Officer

For Company B: Chief Executive Officer

In the event that the designees are not able to resolve any dispute within the 60-day period (or any agreed extension thereof), either Party may invoke the provisions for binding arbitration set forth in Section 13.2.

13.2. *Arbitration.* Subject to Section 13.1, in the event of any dispute, difference, or question arising between the Parties in connection with the Agreement, the construction thereof, or the rights, duties, or liabilities of either Party excluding any dispute or controversy for which arbitration is prohibited by any applicable law or treaty, which dispute is not amicably resolved by good faith negotiations under Section 13.1, then, if either Party so requests, such dispute shall be resolved by binding arbitration. The arbitration shall be conducted under the then-current Commercial Rules of the American Arbitration Association ("AAA Rules"). With respect to any arbitration proceeding held hereunder, either Party has the right to opt for expedited arbitration under the AAA Rules. In addition to the powers conferred by the AAA Rules, the arbitrator shall have authority to order such other discovery as he or she deems appropriate for a full and fair hearing of the case. Within 10 days after the demand for arbitration is given, the Parties shall select a single neutral arbitrator to preside over the arbitration proceeding. If the Parties fail to select an arbitrator within such 10-day period, such arbitrator shall be chosen by _ _[*e.g., the chief judge of the Superior Court of the County of Santa Clara, State of California*]_ _. The arbitrator's decision shall be final and binding, and the award so rendered may be filed in any court having jurisdiction. The costs of arbitration shall be borne by the losing Party. The provisions of this Section 13.2 shall survive the expiration or earlier termination of this Agreement.

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§6.91 14. Form: Miscellaneous Provisions

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6.91-1 Miscellaneous provisions

ARTICLE 13: MISCELLANEOUS

14.1. *Assignment, Successors*. Neither Party shall assign any of its rights or obligations under this Agreement except (a) as incident to the merger, consolidation, or reorganization, or to the acquisition of stock affecting actual voting control or of substantially all of the assets, of the assigning Party; or (b) to an Affiliate; provided, however, that in no event shall either Party's rights or obligations under this Agreement be assigned without prior written notice to the other Party. In any case, neither Party may make any assignment of its assets that renders it unable to perform its obligations under this Agreement. This Agreement shall be binding on, and shall inure to the benefit of, the Parties and their permitted successors and assigns.

14.2. *Retained Rights*. Nothing in this Agreement shall limit in any respect the right of either Party to conduct research and development outside the Field or to develop and market products outside the Field using such Party's technology, but no license to use the other Party's technology to do so is granted in this Agreement, either expressly or by implication. Further, XYZ retains the right, independent of this Agreement, to develop and market XYZ Products in the Joint Territory and to license others to do so.

14.3. *Further Actions*. Each Party agrees to execute, acknowledge, and deliver any further instruments and to take any other actions that may be necessary or appropriate to carry out the purposes and intent of this Agreement.

14.4. *No Trademark Rights*. Except as explicitly provided in this Agreement, no right, express or implied, is granted by this Agreement to either Party to use in any manner the name or any other trade name or trademark of the other Party in connection with the performance of the Agreement.

14.5. *Relationship.* The relationship of the Parties is one of independent contractors, and no agency, partnership, joint venture, or similar relationship is created under this Agreement. Except as specifically authorized in this Agreement, neither Party shall have any authority to assume or create obligations on the other Party's behalf. Neither Party shall take any action that has the effect of creating the appearance of its having such authority.

14.6. *Notices*. All notices and other communications under this Agreement shall be in writing and shall be deemed given if delivered personally or by facsimile transmission (receipt verified), mailed by registered or certified mail (return receipt requested) postage prepaid, or sent by express courier service, to the Parties at the following addresses (or at such other address for a Party as shall be specified by like notice, provided that notices of a change of address shall be effective only upon receipt thereof):

If to XYZ, addressed to:

XYZ Corporation
_ _[*address*]**_ _**

If to ABC, addressed to:

ABC Corporation
_ _[*address*]**_ _**

14.7. *Governing Law.* This Agreement shall be construed and enforced in accordance with the laws of the State of California without regard to principles of conflict of laws that would cause the laws of any other jurisdiction to apply. The Parties expressly agree to exclude the application of the U.N. Convention on Contracts for the International Sale of Goods (1980) to this Agreement and the performance of the parties under this Agreement, to the extent that such convention might otherwise be applicable.

14.8. *Waiver*. Except as specifically provided in this Agreement, the waiver from time to time by either Party of any of its rights or any failure to exercise any of its remedies shall not operate or be construed as a continuing waiver of the same or any other of such Party's rights or remedies provided in this Agreement.

14.9. *Severability*. If any term, covenant, or condition of this Agreement or the application of this Agreement to any Party or circumstance shall, to any extent, be held to be invalid or unenforceable, the remainder of this Agreement, or the application of such term, covenant, or condition to the other Party or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected, and each term, covenant, or condition of this Agreement shall be valid and enforced to the fullest extent permitted by law.

14.10. *Ambiguities*. Ambiguities, if any, in this Agreement shall not be construed against any Party, irrespective of which Party may be deemed to have authored the ambiguous provision.

14.11. *Entire Agreement*. This Agreement and any other agreements referenced in this Agreement set forth all the covenants, promises, agreements, warranties, representations, conditions, and understandings between the Parties with regard to the subject matter of this Agreement, and supersede and terminate all prior agreements and understandings between the Parties with regard to the subject matter of this Agreement. There are no covenants, promises, agreements, warranties, representations, conditions, or understandings, either oral or written, between the Parties with regard to the subject matter of this Agreement, other than those set forth in this Agreement or in any agreement referenced in this Agreement.

14.12. *Headings.* The section headings in this Agreement are for convenience only and are not intended to define or limit the contents of the section to which they apply.

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§6.92 15. Form: Signatures

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6.92-1 Signatures

IN WITNESS WHEREOF, the Parties have executed this Agreement in duplicate originals by their authorized officers as of the date and year first above written.

Date: _ _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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7

Intellectual Property Issues in Merger and Acquisition Agreements

Stephen D. Gillespie

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§7.1 I. INTRODUCTION: ROLE OF INTELLECTUAL PROPERTY COUNSEL

Intellectual property counsel play an increasingly important role in mergers and acquisitions. Although mergers and acquisitions (M&A) practice was traditionally the domain of corporate lawyers, and corporate lawyers still typically lead M&A transaction teams, it is common today to see intellectual property counsel from both sides working as part of the team to draft and negotiate the intellectual property aspects of the agreement. That is as it should be. Even outside the technology sector, technology and intellectual property assets are a significant part of nearly every company's value. Intellectual property claims also pose some of the most serious risks faced by modern business enterprises. A merger, acquisition, or asset sale will itself give rise to intellectual property risks that can disrupt a company's ongoing operations in several ways. For example, as a result of the transaction, companies can lose their rights to use mission critical software or technology licensed from third parties, former employees and contractors may claim rights to key intellectual property assets, and competitors and patent trolls may attempt to exploit the transaction by raising claims of patent infringement after the deal is announced.

Buyers rely on their intellectual property counsel to help assess the value and strength of a company's intellectual property assets, to identify and evaluate the risk of intellectual property claims against the company, to evaluate the effect that the transaction itself will have on the company's ongoing operations, and to help ensure that they receive unencumbered title to the intellectual property assets that they acquire. Sellers in turn rely on their intellectual property counsel to ensure they have made adequate disclosure of any known intellectual property issues, to help assuage any concerns raised by the buyer, and to reduce the risk that the buyer will either refuse to close the transaction after it is announced or bring indemnification claims against the seller after the deal has closed.

The intellectual property provisions of the merger agreement are the primary tools that counsel have at their disposal to perform those critical functions. Intellectual property counsel should be thoroughly familiar with, and actively engaged in, the drafting and negotiation of those sections of the merger or acquisition agreement. It is also important that intellectual property counsel understand the context of the transaction, the business justification, and the core issues that are likely to be encountered in order to tailor the intellectual property representations and warranties appropriately and to avoid inadvertent requests for disclosure that could harm the buyer or seller. For example, a detailed disclosure regarding known infringement of the seller's intellectual property rights could be used to support defenses of estoppel and laches if the buyer ever decides to enforce its intellectual property rights. It is therefore important for intellectual property counsel to "work smart," to be intimately involved with and integrated into the transaction team, and to "take ownership" of the intellectual property aspects of the transaction.

This chapter introduces the typical intellectual property clauses in the primary forms of merger and acquisition agreements and explains the various functions that those clauses perform. It provides practical tools and techniques for drafting and negotiating those clauses from the perspective of intellectual property counsel for both buyers and sellers. For complete forms of business acquisition and merger agreements and general discussion of merger and acquisition transactions, readers should consult Sales and Mergers of California Businesses (Cal CEB 2002). For an overview of the major considerations in intellectual property-focused mergers and acquisitions, see §§3.39-3.57.

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§7.2 II. FUNCTIONS OF INTELLECTUAL PROPERTY REPRESENTATIONS AND WARRANTIES

The intellectual property representations and warranties in a merger or acquisition agreement serve four interrelated functions:

- They confirm for the buyer that the seller has disclosed all relevant issues and information, including the information needed by the buyer to effect a smooth transition and integration of the seller's business postclosing;
- They allocate the risk of intellectual property claims arising from the seller's business;
- They create closing conditions that may enable the buyer to get out of the deal prior to closing; and
- They create postclosing remedies.

These key functions are discussed in §§7.3-7.9.

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§7.3 A. Confirming Seller's Disclosures

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One of the most important functions of the intellectual property provisions in a merger agreement is to ensure complete and full disclosure by the seller of all material intellectual property issues related to its business. For the buyer, complete disclosure is critical to an accurate valuation of the seller (or the seller's assets) and assessment of any risks posed by the acquisition. It also provides information needed to effect a smooth transition (such as lists of material agreements with suppliers and software vendors that are necessary to the continued operation of the seller), and serves to identify any action that must be taken after closing in order to continue prosecution and maintenance of patents, trademarks, and pending applications.

For the seller, complete disclosure mitigates risk of liability for breach of representations and warranties, and can be used to allocate any known risks to the buyer. As discussed in chaps 3 and 4, as part of the due diligence process, among other things, buyer's counsel should have requested and obtained from the seller all of the seller's material contracts; current dockets for any patents, trademarks, and copyrights and any pending applications; and lists and correspondence concerning any pending or threatened litigation or patent notice letters. The intellectual property representations and warranties serve to confirm that the buyer has received through the diligence process a complete and accurate disclosure of those matters. The primary mechanism for that function is the seller's disclosure schedule, a document cross-referenced to the parties' main agreement that operates to qualify the seller's representations and warranties. The merger agreement typically provides that the representations and warranties of the seller are true and correct *except as otherwise disclosed on the seller's disclosure schedule*. See, *e.g., Koninklijke Numico N.V. v KEP Enterprises LP*, (D Del 2003) 2003 US Dist Lexis 5135 (disclosure schedule qualifies representations and warranties).

Following is a typical introduction to the representations and warranties in a merger agreement.

Subject to the disclosures set forth in the disclosure letter of the Company delivered to Acquirer concurrently with the parties' execution of this Agreement (the "Company Disclosure Letter") (each of which disclosures, in order to be effective, shall clearly indicate the Section and, if applicable, the Subsection of this Article to which it relates), the Company represents and warrants to Acquirer as follows….

The seller's disclosure letter typically operates in the following manner: The buyer usually requires a representation and warranty from the seller that there are no pending or threatened claims or litigation regarding any infringement by the seller of any intellectual property rights and that the seller has not received any patent notice letters or offers of a patent license. An example of such a warranty is presented in §7.28. If the seller is aware of any such infringement claims or notices, the seller will disclose them on its disclosure schedule. As a result, the seller will not be in breach of the warranty, and the buyer will take the assets subject to the existing infringement claims and patent notices that are disclosed in the seller's disclosure letter. If a disclosed claim is sufficiently serious, buyer's counsel may recommend either (1) not proceeding with the transaction, (2) reducing the purchase price, or (3) reserving part of the purchase price in an escrow to be used to pay legal fees and other costs of defending against the claim and to indemnify the buyer against any liability arising from the claim. As discussed in §§7.6-7.8, indemnification escrows are a very common approach in mergers and acquisitions of private companies, but are not typically found in acquisitions of public companies.

If a seller discloses an issue on the disclosure schedule that the buyer did not learn through its due diligence, buyer's counsel may hold up the signing in order to investigate fully and obtain more complete disclosure of that issue. Buyer's counsel should therefore ensure that the scope of the intellectual property representations and warranties is sufficiently broad to force the seller to disclose every issue that the buyer needs to know in order to assess the risk of the transaction and to enable a smooth transition and integration of the seller's business.

Seller's counsel should ensure that the seller has made full and complete disclosure of all material issues in due diligence and that the seller fully discloses all issues in the seller's disclosure schedule in order to shift liability for any

known risks to the buyer. Seller's counsel should also prepare and deliver the disclosure schedule as far in advance of the anticipated signing date as possible, to avoid last-minute disclosures. Withholding material information until the last minute and then dropping it on the buyer in the disclosure schedule is an all-too-common practice, and it often backfires. Buyers have walked away from multi-million dollar acquisitions based on last-minute disclosures and the impression created that the seller has engaged in intentional deception. Through full, honest, and early disclosure, both parties know what they are getting into and can realistically assess and mitigate any intellectual property risks posed by the seller's business.

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§7.4 B. Risk Allocation

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Another key function of the intellectual property provisions is to allocate risk between the buyer and seller. For example, in addition to the representation that there are no pending or threatened infringement claims, buyers typically seek a representation and warranty that the seller's products do not infringe any third party's intellectual property rights. An example of a noninfringement warranty is presented below. See also §7.29.

The operation of the business of the Company as such business is currently conducted and as currently proposed to be conducted, including (i) the design, development, manufacturing, reproduction, marketing, licensing, sale, offer for sale, importation, distribution, provision, or use of any Company Product and (ii) the Company's use of any product, device, or process used in the business of the Company as currently conducted and as currently proposed to be conducted by the Company, does not and will not infringe or misappropriate the Intellectual Property of any third party.

Note that this representation and warranty seeks more than a simple disclosure of claims or allegations known to the seller. If a third party patent holder has not given any notice to the seller, the seller may be unaware of any potential infringement. Most companies do not attempt to locate third party patents that they might be infringing, preferring instead to avoid any knowing infringement by remaining ignorant of those patents until the patent holder decides to give notice. As a result, seller's counsel often resists making an unqualified noninfringement warranty, arguing that the risk of infringing patents of which the seller is unaware should be borne by the buyer, because that risk is inherent in running any technology business. Buyers typically counter that if a risk arises before closing ("on the seller's watch," so to speak), that risk is most appropriately borne by the seller. Buyers also argue that a patent infringement claim could substantially diminish the value of the seller's business, and hence that the seller would be unfairly overcompensated if an infringement claim were to arise after closing. Some of the ways that parties use risk-shifting, indemnity, and liability caps to reach an appropriate and mutually agreeable allocation of risks with respect to infringement claims are explored in more detail in §§7.6-7.13 and in the discussion of particular representations and warranties in §§7.21-7.43.

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§7.5 C. Creating Closing Conditions

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Another function of intellectual property representations and warranties is to create closing conditions, which give the buyer an opportunity to get out of the deal before closing if a condition is not satisfied. Most M&A agreements contemplate some period of time between signing of the agreement and closing of the transaction. During that time, the seller's management will continue to run the company, subject to detailed obligations regarding conduct of the business between signing and closing, as well as obligations to obtain the buyer's approval for any transactions outside of the ordinary course of business. Between signing and closing, the seller will also be obligated to obtain any necessary shareholder and regulatory approvals, and the transaction may be subject to review by federal (and sometimes state) agencies to address antitrust issues. Typically, the merger or acquisition agreement will provide that the representations and warranties of the seller must be true both as of the agreement date and as of the closing date, and that it is a condition of the buyer's obligation to close the transaction that the representations and warranties be true as of the closing date. This condition is thus referred to as a "closing condition" or a "bring-down" clause. Following is an example of a "bring-down" clause.

The obligations of Acquirer to consummate the transactions contemplated hereby shall be subject to the satisfaction at or prior to the Closing of each of the following conditions:

(i) The representations and warranties of the Company in this Agreement shall be true and correct in all material respects on and as of the Agreement Date and on and as of the Closing Date as though such representations and warranties were made on and as of such date.…

The closing conditions create a powerful (although seldom invoked) remedy for the buyer in the event that a breach of the representations and warranties is either discovered or arises during the period between signing and closing. Especially for a seller that is a public company, a buyer's refusal to close the acquisition after the deal has been announced to the public could devastate the seller's stock price, so sellers often push hard to limit the buyer's rights to get out of the deal after signing. (Sellers seek what is known as "deal certainty.") But buyers, especially if they are also public companies, may face liability from their own shareholders if they close a transaction despite a known liability that significantly impairs the value of the assets or company being acquired. Hence, the closing conditions are often among the most hotly contested provisions of an M&A agreement. Section 7.13 discusses how sellers often succeed in qualifying the bring-down provision with a "no material adverse effect" clause in order to maximize deal certainty between signing and closing.

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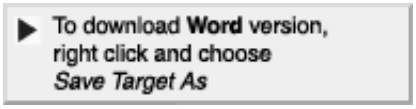
§7.6 D. Postclosing Remedies

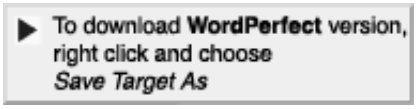
Another key function of intellectual property representations and warranties is to create postclosing remedies for breach. As discussed in §7.9, such postclosing remedies are typically not available in a merger or acquisition of a public company. But in mergers and acquisitions of private companies, it is typical for the representations and warranties to survive for a period between 1 and 2 years after closing, and for the agreement to include a specific indemnification from the seller for any claims, liabilities, or losses arising from any failure of the representations and warranties to be true. See *Herring v Teradyne, Inc.* (SD Cal 2002) 256 F Supp 2d 1118, 1126, aff'd in part and rev'd in part (9th Cir 2007) 242 Fed Appx 469 (unpublished), quoting Thompson, Business Planning for Mergers and Acquisitions 779 (3d ed 2008). See also *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947, 954 (1-year survival clause in stock purchase agreement specified when breach of representations and warranties may occur, not when action must be filed). Often, the parties will also agree to reserve some part of the consideration, typically between 10 and 20 percent, to cover any claims or losses that arise during the 1 or 2 years after closing. To draft and negotiate the intellectual property provisions in the M&A agreement effectively, it is important for intellectual property counsel to understand, and participate in the negotiation and structuring of, the agreement's indemnity and escrow provisions.

NOTE: For a detailed discussion of indemnification clauses in M&A agreements, see Brockmeyer & Waxman, *Indemnification Provisions in Business Acquisition Agreements*, 18 CEB Cal Bus L Prac 69 (Fall 2003).

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§7.7 1. Indemnification





Following is an example of a typical indemnification clause. Note that, in this example, the indemnity specifically includes direct claims by the acquirer "whether or not due to a third party claim." Seller's counsel should consider carefully whether the seller is willing to provide such broad coverage and may want to push to limit the seller's indemnification obligation to liability arising from third party claims.

Seller shall indemnify and hold harmless Acquirer and its officers, directors, agents, and employees from and against any and all Damages arising from assessments, Taxes, claims (including direct claims by Acquirer), demands, assertions of liability, actions, suits, or proceedings, whether or not due to a third party claim, directly or indirectly arising out of, resulting from, or in connection with any failure of any representation or warranty made by the Company in this Agreement or the Company Disclosure Letter (including any exhibit or schedule to the Company Disclosure Letter) to be true and correct as of the Agreement Date and as of the Closing Date.

Because indemnification is often the sole remedy for any losses arising from breach of an intellectual property representation or warranty, buyer's counsel often seeks to ensure that the definition of covered losses is sufficiently broad to cover all costs and expenses that the buyer may be forced to incur as a result of the breach. Courts have held, for example, that an indemnification for "liabilities" incurred by the buyer covered only sums owed to third parties, and not any diminution in value of the acquired company resulting from the breach. In *Network Publishing Corporation v Jerome Shapiro* (2d Cir 1990) 895 F2d 97, 99, the court found that while the term sheet had specified indemnification for "losses," the merger agreement limited indemnification to "liabilities." Because the term "liabilities" implies amounts owed to third parties, the court held that the indemnification did not cover any diminution in value arising from breach of warranties regarding the seller's financial condition. Buyer's counsel should therefore ensure that the indemnification covers "losses" incurred by the buyer, including diminutions in value, as well as any costs incurred to remedy the breach. Such costs might include, *e.g.,* costs to redesign the seller's product to avoid a patent infringement claim, or to remove undisclosed open source software from the seller's product in order to avoid liability for failing to comply with the terms of the open source license.

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§7.8 2. Escrows and Deferred Consideration

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As noted in §7.6, it is common in mergers and acquisitions of private companies for the parties to agree to place some part of the consideration into an escrow account, to be used to pay any indemnification claims that mature during a specified time period after closing. That period typically corresponds to the period during which the representations and warranties survive, often 1 to 2 years after closing. Depending on the size of the transaction, the escrow amount is typically in the range of 10 to 20 percent of the consideration. It is relatively common after a deal has closed for the buyer to make a claim against the escrow for damages arising from one or more breaches of the representations and warranties, including legal fees and settlement amounts for patent claims and claims by employees, fines paid to regulatory agencies for undisclosed liabilities, and amounts paid to customers to settle undisclosed warranty or breach-of-contract claims. After any claims are paid from the escrow, any funds remaining in the escrow are distributed to the seller.

To obtain deal certainty and to ensure that the buyer cannot rescind the acquisition agreement after closing, sellers typically push hard for a provision that indemnification up to the amount in the escrow fund will be the sole and exclusive remedy for any breach of the seller's representations and warranties. Buyers typically agree that indemnification will be the sole and exclusive remedy, except in case of fraud by the seller. See *JHW Greentree Capital, L.P. v Whittier Trust Company* (SD NY 2005) 2005 US Dist Lexis 27156 (exclusive remedy clause provided that indemnification would be sole remedy for any misrepresentation arising out of merger agreement, except for claims of fraud). Following is an example of an "exclusive remedy" clause.

If the Merger is consummated, recovery from the Escrow Fund shall constitute the sole and exclusive security and remedy for the indemnification obligations under this Agreement, except in the case of fraud, willful breach, or intentional misrepresentation by the Company.

The amount of the escrow and the sole remedy provisions are often negotiated at the term sheet stage. To draft and negotiate the intellectual property representations and warranties effectively, intellectual property counsel should be aware of these provisions and the limitations that they impose on effective remedies for breach of the representations and warranties. If buyer's counsel learns of a particular high-risk exposure, he or she may want to argue for a special indemnification covering that exposure (despite any disclosure in the seller's disclosure schedule) and to carve that indemnification out of any caps on liability imposed by the escrow clauses.

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§7.9 3. Remedies in Mergers and Acquisitions of Public Companies

In mergers and acquisitions of public companies, the postclosing remedies are usually limited to an action for fraud against the seller's management, typically under Rule 10b-5 (17 CFR §240.10b-5) of the Securities Exchange Act of 1934 (15 USC §§78a-78nn). See, *e.g., Atari v Ernst & Winney* (9th Cir 1992) 981 F2d 1025 (rejecting Atari's Rule 10b-5 claims due to lack of "reasonable reliance" on seller representations and warranties). Whether the acquisition is through a tender offer of cash in exchange for the stock of a public company or through some form of statutory merger, the representations and warranties in an acquisition of a public company typically do not survive beyond the closing date. Once the consideration is paid to the public company's shareholders, it is not feasible to rescind the purchase agreement for breach of warranty. As a result, in the absence of fraud on the part of the seller's management, the buyer will typically have no remedy after the closing date for breach of the representations and warranties in the agreement. Accordingly, in acquisitions of public companies, the primary functions of the intellectual property provisions in the agreement are (1) to ensure a complete and full disclosure of liabilities and issues related to intellectual property; and (2) to give the buyer a final opportunity to get out of the deal if a material breach of the representations and warranties is discovered before closing.

Another important issue in drafting and negotiating the intellectual property provisions in mergers and acquisitions of public companies is the appropriate scope of the representations and warranties. Often, the buyer and seller in public-public mergers will each have significant (and sometimes nearly equal) market capitalization, so the seller will expect the buyer to make reciprocal representations and warranties. Other common assumptions are that any material liabilities of the seller will have been publicly disclosed in its SEC filings or will otherwise be generally available from public sources, and that most liabilities or other consequences of the merger transaction will not have a material adverse effect on the buyer or seller. Given those considerations and the fact that the representations and warranties will not create any postclosing remedies, it is common in public-public mergers, especially mergers of equals or near-equals, to see fairly streamlined intellectual property representations and warranties. A merger or acquisition agreement for a private company might have 25 to 30 intellectual property representations, but a public merger agreement may have only two or three.

For example, in the merger agreement negotiated between Hewlett-Packard (HP) and Compaq, Compaq gave only two intellectual property representations and warranties: (1) a representation that as of the signing date there was no infringement of intellectual property rights that would have a material adverse effect on its business, and (2) a representation that Compaq was not party to any contract that would, as a result of the merger, subject HP to any material noncompete or exclusivity provisions or otherwise encumber any HP intellectual property, in each case that would have a material adverse effect. HP gave only a reciprocal noninfringement representation. See *Agreement and Plan of Reorganization,* dated as of September 4, 2001, filed with the U.S. Securities and Exchange Commission as Exhibit 2.1 to the Form 8-K Report filed by HP on September 4, 2001.

Although the HP-Compaq merger is a relatively extreme example, when advising clients in mergers and acquisitions of public companies, counsel should consider carefully the appropriate scope of intellectual property representations and warranties in light of (1) the likelihood of reciprocity in the agreement; (2) the availability of relevant information from public sources; and (3) the limited remedies that may be available in the event of any breach.

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§7.10 III. LIMITING SELLER'S LIABILITY

Counsel representing buyers typically seek a broad set of intellectual property representations and warranties in order to achieve the buyer's objectives discussed in §§7.2-7.9. In contrast, seller's counsel works to minimize the risk that the seller may be liable for breach of the representations and warranties, to minimize the risk of any indemnification claims after closing (so as to maximize the amount of escrow funds that will be distributed to the seller at the end of the escrow period), and to achieve deal certainty by minimizing the risk that the buyer will refuse to close the transaction based on a breach of a representation or warranty arising between signing and closing. As discussed in §7.3, complete and early disclosure of known issues is one of the best ways that seller's counsel can protect their clients. In addition, seller's counsel should negotiate to ensure that there is a reasonable cap on the seller's liability and that a claim against the escrow fund is the sole and exclusive remedy for any breach of the seller's representations and warranties.

Sections 7.11-7.13 explore some of the other tools that seller's counsel can use to minimize the seller's risk and maximize deal certainty. Short of simply deleting some or all of the representations and warranties in the buyer's form agreement—a technique that seller's counsel often attempt, but with limited success in most transactions—seller's counsel can limit the seller's risk through a combination of the following: (1) limiting the time of application of one or more representations and warranties, (2) using knowledge qualifiers, and (3) using materiality qualifiers.

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§7.11 A. Time of Application

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The time of application is an important aspect of intellectual property representations and warranties, and is dictated in part by the type of transaction. In stock purchases and mergers, buyer's counsel typically start negotiations from the position that the representations and warranties must be true both at signing and at closing, and that the representations and warranties will survive for a period of 1 or 2 years after the closing. Sometimes buyer's counsel will negotiate for a longer or indefinite survival period for certain representations and warranties, such as the noninfringement warranty (see §7.29). Survival of representations and warranties means that the buyer can seek indemnification for claims arising during the specified period after closing if the claim would have made one or more of the representations and warranties untrue at closing. For example, if the buyer receives notice of a patent infringement claim after closing but the patent was issued before closing, then the product allegedly infringed the patent before closing. Hence, the noninfringement warranty would have been untrue at the time of closing, and the buyer can seek indemnification from the seller.

Seller's counsel can limit the seller's burden of disclosure and risk of liability by narrowing the applicable timeframes for given representations. For example, consider the following buyer's form of a typical noninfringement warranty (see also §7.29):

The operation of the business of the Company as such business is currently conducted and as currently proposed to be conducted, including (i) the design, development, manufacturing, reproduction, marketing, licensing, sale, offer for sale, importation, distribution, provision, or use of any Company Product and (ii) the Company's use of any product, device, or process used in the business of the Company as currently conducted and as currently proposed to be conducted by the Company, does not and will not infringe or misappropriate the Intellectual Property of any third party.

Note that buyer's counsel wants the warranty to apply not only to operation of the business as currently conducted by the seller, but also to the operation of the business "as currently proposed to be conducted." Further, buyer's counsel wants the seller to represent not only that the operation of the business "does not infringe," but also that such operation "will not infringe." For the buyer, those forward-looking representations shift the risk of future infringement claims to the seller.

For example, if the seller had plans to launch a new product sometime within the survival period for the representation, the buyer would argue that the launch of that product is within the meaning of operation of the business "as currently proposed to be conducted." If the buyer goes forward with the proposed launch after closing, but later receives a claim alleging that the new product infringes a third party's patent, then the buyer could seek indemnification from the seller. Seller's counsel should object, however, arguing that the risk of infringement claims against new products launched by the buyer after closing should be born by the buyer. The seller would likely not have learned of a patent claim unless and until the product was released, and the risk of patent claims is a risk of doing business that applies equally to the buyer's own products. Why, seller's counsel often ask, should the seller act as an insurer against the buyer's risk of doing business? Seller's counsel should also negotiate to strike the forward-looking warranty that the operation of the business "will not infringe," because that warranty could give the buyer coverage for patents that issue after the closing date. Seller's counsel could argue again that the risk of infringement claims under such patents, which were not even effective before the closing date, should be born by the buyer.

Seller's counsel might redline the representation as shown below:

To the knowledge of the Company, ~~T~~the operation of the business of the Company as such business is currently conducted ~~and as currently proposed to be conducted~~, including (i) the design, development, manufacturing, reproduction, marketing, licensing, sale, offer for sale, importation, distribution, provision or use of any Company Product and (ii) the Company's use of any product, device, or process used in the business of

the Company as currently conducted ~~and as currently proposed to be conducted by the Company,~~ does not ~~and will not~~ infringe or misappropriate the Intellectual Property of any third party that is issued and effective as of the closing date.

The use of knowledge qualifiers is discussed in §7.12.

NOTE: In an asset purchase, the time of application of certain representations may be less relevant. For example, the seller will usually agree to retain all liability for any infringement claims that arose before closing. (Such liability is typically defined as an "excluded liability," to be borne solely by the seller.) In that case, it is not necessary for the buyer to obtain a noninfringement representation concerning past infringement. Of course, buyer's counsel may want to obtain at least a representation that the seller is not aware of any past infringement or allegations of infringement, so that the buyer is made aware of any known liabilities with respect to the assets being purchased. The seller may also resist making any representation with respect to infringement claims arising after closing on the ground that the buyer should bear the risk, rather than asking the seller to act as an insurer against future claims of which the seller is not aware, especially regarding patents that issue after closing.

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§7.12 B. Knowledge Qualifiers

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Seller's counsel use knowledge qualifiers like that shown in the second example in §7.11 to limit the seller's risk of liability for unknown claims. In the context of a noninfringement representation, such a knowledge qualifier essentially shifts all risk of infringement claims to the buyer, because the seller will disclose all known claims in the seller's disclosure letter, and the buyer will therefore have no remedy if a claim arises after closing. As discussed in §7.11, seller's counsel often argue that that is the appropriate result, because the risk of patent claims is simply a risk of doing business and the seller should not be required to insure the buyer against such risks. Buyer's counsel often counter that the cap on overall liability established through the escrow mechanism discussed in §7.8 appropriately allocates the risk between the buyer and the seller, and therefore the seller should not have the benefit of the knowledge qualifier. In most transactions, the buyer's argument wins the day and the seller does not get a knowledge qualifier on the noninfringement warranty, unless the seller has significant leverage.

Intellectual property counsel negotiating over knowledge qualifiers on various representations and warranties should be cognizant of the fact that corporate attorneys often negotiate a specific definition of "knowledge." Seller's corporate counsel often argue for a narrow definition of "knowledge," to include only those issues of which a named group of seller's management had actual knowledge. Buyer's counsel usually argues for a broader definition of "knowledge," to include issues that any employee of the seller either knew or would have known with diligent inquiry (so called "imputed knowledge"). The parties often land somewhere in between the two extremes, so it is important for intellectual property counsel to be involved in those negotiations.

Following is an example of a negotiated definition of knowledge:

"Knowledge" means, with respect to Company, the knowledge of such fact, circumstance, event, or other matter after reasonable inquiry of _ _[*insert names of seller's management*]_ _. Any such seller representative will also be deemed to have knowledge of a particular fact, circumstance, event, or other matter in question if such knowledge could be obtained from reasonable inquiry of the persons employed by such representative.

In general, buyer's counsel should push hard to limit the use of knowledge qualifiers, especially for the noninfringement and other warranties where a knowledge qualifier essentially "guts" the warranty. There are, however, some typical representations where a knowledge qualifier is reasonable, *e.g.,* a representation concerning whether there has been any infringement of the seller's intellectual property by third parties.

In mergers and acquisitions of public companies, a knowledge qualifier is implicit in the representations. Because the representations and warranties do not survive closing, if the parties do not learn of a breach before closing, the representation will not affect the transaction. Buyer's counsel will not want knowledge qualifiers on any important representation, however, because it will not want to have to prove that the seller had "knowledge" of the breach before closing.

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§7.13 C. Materiality Qualifiers

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In addition to knowledge qualifiers, seller's counsel often argue for materiality qualifiers on certain representations and warranties to reduce the risk of seller liability (or a refusal by the buyer to close the transaction) for some immaterial breach of the representations and warranties. There are two common types of materiality qualifiers: "material adverse effect" and simple materiality.

Material adverse effect (MAE) is a term of art that has been interpreted as imposing a very high threshold, requiring a material adverse impact on the financial conditions of the company or results of its operations taken as a whole. Especially when the buyer or the seller is a large public company, a very significant breach of the representations and warranties would be required to cause a material adverse effect. For example, in the *Tyson Foods* case, the Delaware chancery court held that even a significant failure of the target to meet its projections did not rise to the level of an MAE; hence, Tyson was not entitled to get out of the deal based on the closing conditions. See *IBP, Inc. v Tyson Foods* (Del Ch 2001) 789 A2d 14, 68 (MAE requires "occurrence of unknown events that substantially threaten the earning potential of the target"). Similarly, in *Frontier Oil,* the same court held that even a toxic tort lawsuit brought between signing and closing, which the court acknowledged could be "catastrophic" and could result in litigation costing at a minimum between $15 and $20 million, did not rise to the level of causing an MAE permitting Holly to get out of the purchase, which was valued at $338 million. *Frontier Oil Corp. v Holly Corp*. (Del Ch, Apr. 29, 2005, No. 20502) 2005 Del Ch Lexis 57. A so-called "MAE qualifier" on the representations and warranties or closing conditions will therefore significantly lessen the value of the representations and warranties to the buyer.

Simple materiality is a lower threshold, and courts will look to the ordinary meaning of "material" to determine whether a given issue is or is not material. See, *e.g., Allegheny Energy, Inc. v DQE, Inc.* (WD Pa 1999) 74 F Supp 2d 482, 517 (material means "having real importance or great consequences"). Although a major patent claim that costs millions of dollars to litigate and resolve would not necessarily have a "material adverse effect" on a large public company, it would most likely be considered a "material" issue.

Seller's counsel typically negotiate for materiality qualifiers with respect to certain individual representations and with respect to closing conditions as a whole. For example, buyer's counsel will typically request a warranty that the seller's products conform to all contractual warranties (see §7.41), as in the following example:

All Company Products sold, licensed, leased, or delivered by the Company to customers and all services provided by or through the Company to customers on or prior to the Closing Date conform to all applicable contractual commitments and express and implied warranties made by the Company.

Seller's counsel would typically add a materiality qualifier, so that the representation would read as follows:

All Company Products sold, licensed, leased, or delivered by the Company to customers and all services provided by or through the Company to customers on or prior to the Closing Date conform <u>in all material respects</u> to all applicable contractual commitments and express and implied warranties made by the Company.

To reduce the risk even further, seller's counsel could add an MAE qualifier, as follows:

Except as would not have a material adverse effect on the Company, all Company Products sold, licensed, leased, or delivered by the Company to customers and all services provided by or through the Company to customers on or prior to the Closing Date conform in all materials respects to all applicable contractual commitments and express and implied warranties made by the Company.

Buyer's counsel would typically accept the simple materiality qualifier, but should reject the MAE qualifier, because that would significantly lessen the value of the representation to the buyer, and leave the buyer with little or no remedy in the event of a significant breach of contract or warranty claim from a customer of the seller.

Seller's counsel typically has more success negotiating for material adverse effect qualifiers on the closing conditions as a whole. Especially in acquisitions of public companies, where a refusal by the buyer to close after the transaction has been announced to the public could be devastating to the seller, a typical compromise is to provide that the buyer can refuse to close only in the event that a failure of the representations and warranties to be true and correct as of the closing date would reasonably be expected to have a "material adverse effect" on the buyer. Here is a typical formulation from a negotiated transaction:

The obligations of Buyer to effect the Merger shall be subject to the satisfaction at or prior to the Closing of the following conditions:

(i) The representations and warranties of the Company set forth herein shall be true and correct, in each case both when made and at and as of the Closing Date, as if made at and as of such time, except to the extent that the failure of any such representations and warranties to be so true and correct does not have, and would not reasonably be expected to have, individually or in the aggregate, a material adverse effect on the Company….

Note the focus on "reasonable expectations." Buyer's counsel negotiates for that concept to ensure that the material adverse effect does not actually need to occur between signing and closing. If there is an event that would reasonably be expected to give rise to an MAE, even sometime in the future, the buyer can refuse to close the transaction. When negotiating intellectual property representations and warranties, therefore, intellectual property counsel should be cognizant of any materiality qualifiers and their potential impact on the remedies that may be available to the buyer.

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§7.14 IV. HOW DEAL STRUCTURE AFFECTS INTELLECTUAL PROPERTY CONSIDERATIONS

The form and structure of a given transaction will impact the nature and scope of intellectual property provisions in the agreement, so it is important to be familiar with the principal types of mergers and acquisitions. Federal and state corporation, securities, antitrust, and tax laws governing mergers and acquisitions are complex and nuanced, and the structure of a given transaction is usually driven by tax and securities considerations that are not within the control of intellectual property counsel. For purposes of drafting and negotiating the intellectual property provisions in an M&A agreement, intellectual property counsel can leave much of the detail regarding structure to the corporate lawyers. It is useful, however, to know the basic structures and how they typically impact the nature and scope of intellectual property provisions in the agreement.

Companies can merge or be acquired through three basic mechanisms: (1) stock purchases (see §7.15); (2) statutory mergers (see §§7.16-7.19); and (3) asset purchases (see §7.20). For more detailed discussion of alternative structures for mergers and acquisitions, see Sales and Mergers of California Businesses (Cal CEB 2002). See also §§4.39-4.47. For discussion of federal tax considerations in acquisitions and sales of intellectual property, see §§10.16-10.46.

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§7.15 A. Stock Purchases

In a stock purchase, the acquiring corporation pays cash to the owners of the target company's stock, the buyer becomes the parent, and the target entity continues intact as a subsidiary of the buyer. Acquiring companies can also issue their own stock to the shareholders of a target company in exchange for a controlling interest in the target, in a transaction known as a "stock-for-stock exchange." Such exchanges are subject to special corporate, tax, and securities law treatment. From an intellectual property perspective, stock purchases have some important benefits over other forms of mergers or acquisitions. The most important is that the target's corporate identity remains intact as a subsidiary of the buyer. As a result, any liabilities of the target entity remain with that entity and are not transferred up to the buyer. Because buyers often have deeper pockets, it can be beneficial to keep the target's liabilities isolated in the subsidiary, especially if there is pending or threatened litigation or patent infringement claims against the target.

In addition, maintaining the corporate form of the target as a going concern means that contracts between the target and third parties remain in place with the target and do not need to be assigned to the buyer. See, *e.g., Richardson v La Rancherita of La Jolla* (1979) 98 CA3d 73, 159 CR 285. That is a key advantage over other structures in which the target is dissolved or merged with the buyer and as a consequence the target's contracts must be assigned to the buyer. Assignment of the target's contracts is one of the most vexing problems in mergers and acquisitions. Most companies depend on hundreds of contracts with third parties—contracts with suppliers and manufacturers, real estate and equipment leases, licenses to use mission-critical software and technology, and contracts with customers, distributors, resellers, and contractors. Many contracts cannot be assigned or transferred without consent of the other party to the contract. Buyers and sellers depend on their intellectual property counsel to ensure that the target's material contracts remain in force after the transaction is closed. That task is made easier in a stock purchase, because the target continues to exist and its contracts do not need to be assigned. Hence, it is not necessary to identify and schedule all of the contracts that require the other party's consent to an assignment, which is often among the most difficult and time-consuming jobs assigned to the intellectual property team on a merger or acquisition.

Although a stock purchase does not require assignment of the target's contracts, many contracts include a right to terminate on a change of control of one or both parties. Because a stock purchase does cause a change of control of the target, intellectual property counsel must ensure that all contracts with a termination right on a change of control have been identified and that the parties have a contingency plan to mitigate the risk of any terminations.

Intellectual property counsel should also be aware that, although the seller remains intact as a corporate subsidiary after a stock purchase, buyers often decide sometime after closing an acquisition that they want to absorb or "roll up" their newly acquired subsidiaries, usually for tax reasons. In that event, all of the target's contracts will have to be assigned to the corporate parent. Hence, even when the deal is structured as a stock purchase, the attorneys reviewing the target's contracts should identify those contracts that would require the consent of the other party to an assignment, so that the contracts need not be reviewed again when the parent decides to restructure and roll up its subsidiaries.

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§7.16 B. Statutory Mergers

In a statutory merger, the acquired corporation is merged directly into the acquiring corporation, the shareholders of the target company become shareholders of the surviving corporation, and all of the disappearing corporation's business, assets, contracts, and liabilities are assigned or transferred to the surviving corporation by operation of law. The three primary structures for statutory mergers are "straight-in mergers," "forward triangular mergers," and "reverse triangular mergers." See §3.44. See generally Sales and Mergers of California Businesses (Cal CEB 2002). Each of the three structures impacts key intellectual property issues differently, so it is important for intellectual property counsel to be familiar with each structure and to learn early in planning for a given transaction which of the three structures will be involved. (In some transactions, for tax and securities reasons beyond the scope of this chapter, a transaction will be structured as a "reverse triangular merger" to be followed immediately by a "forward triangular merger.")

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§7.17 1. Straight-In Mergers

In a straight-in merger, one or more target companies are merged directly into the buyer corporation, and all of the business, assets, and liabilities of the target corporation are transferred to the buyer by operation of law. From an intellectual property perspective, a straight-in merger has two principal disadvantages. First, if the target has any material liabilities (*e.g.,* a patent infringement issue), those liabilities will be transferred to the buyer. Because the buyer often has deeper pockets than the target, the liabilities could loom larger and be harder to resolve after the acquisition is completed. To mitigate any risk to the buyer, it is often better, therefore, to utilize a structure in which the liabilities of the target remain in a subsidiary of the buyer, rather than having the liabilities transferred directly to the buyer-parent corporation.

The second disadvantage is that the seller's contracts must be assigned to the surviving corporation. Although many contracts can be freely assigned to the surviving corporation without consent of the other party, others cannot. As discussed above, identifying which of the target's contracts require the other party's consent to an assignment can often be a difficult and time-consuming task. Contracts that grant patent, copyright, or trademark licenses generally cannot be assigned without consent (see, *e.g., Cincom Sys., Inc. v Novelis Corp*. (6th Cir Sept 25, 2009, No. 07-4142) 2009 US App Lexis 21172; *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237, 240), and many contracts include an express provision prohibiting assignment without consent. When consent is required, obtaining consent of course depends on the willingness of the other party to the contract to grant consent. Most parties willingly grant their consent to assignment, but some do not. Many software vendors, for example, do not routinely consent to assignment of their software licenses, preferring instead to require payment of additional license or maintenance and support fees for any use of their software by the surviving corporation. Other parties will withhold consent to assignment of their contracts if they believe the buyer is a potential competitor or if they simply wish to exploit the opportunity to renegotiate terms or extract additional fees.

As a result, in a forward merger, buyer's counsel should impose two requirements related to the target's contracts: first, counsel should require the seller to identify and schedule all agreements that will require consent to assignment, and second, counsel should require that, as a closing condition, the target obtain consent to assign those contracts that are critical to the continuing operation of the target's business. The second requirement is often a hotly contested issue, because the target will not want to accept any risk that the buyer might refuse to close the transaction, especially when the risk depends on the willingness of third parties to consent to the assignment.

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§7.18 2. Forward Triangular Mergers

To isolate any target company liabilities in a subsidiary and for other tax and securities reasons, many statutory mergers are structured as forward triangular mergers rather than straight-in mergers. In a forward triangular merger, the buyer creates a new subsidiary and capitalizes the subsidiary with sufficient cash and stock to acquire the target. The target entity is then merged with and absorbed into the new subsidiary, and all of the target's business, assets, contracts, and liabilities are assigned and transferred to the subsidiary, rather than to the parent company. From an intellectual property perspective, a forward triangular merger has the benefit of shielding the buyer-parent from the target's liabilities, which can be beneficial especially if there is pending or threatened litigation or patent infringement claims against the target. Because the contracts are assigned to the acquisition subsidiary by operation of law, however, buyer's counsel must still identify and schedule all contracts that require consent to assignment, and should require the target to obtain consents to assign any critical contracts as a condition to closing.

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§7.19 3. Reverse Triangular Mergers

The third form of statutory merger is the reverse triangular merger. Reverse triangular mergers have the benefit of preserving the target company's separate legal identity, and thus (as in a stock purchase) there is no need for an assignment of the target's contracts to the buyer. Reverse triangular mergers are similar to forward triangular mergers, but the surviving corporation is the target company rather than the acquisition subsidiary of the parent-buyer. First, the parent-buyer forms a wholly-owned subsidiary and contributes shares of its own stock to be used for the acquisition in exchange for the subsidiary's stock. That subsidiary is then merged into the corporation to be acquired (the target), and the target's voting shares are issued to the parent. The shares of the parent that were held by the acquisition subsidiary are then distributed to the target's shareholders as consideration for the merger, with the result that the target's shareholders become shareholders of the parent, and the separate legal identity of both the parent and the target are preserved.

As discussed with respect to straight-in mergers, it is not necessary in a reverse triangular merger to identify and schedule all of the contracts requiring a consent to assignment, or to require such consent as a closing condition, but it is a good idea to have the attorneys who are reviewing the seller contracts identify any restrictions on assignment in case the parent later wishes to roll up the target-subsidiary. In that event, all of the target's contracts would need to be assigned to the parent. It is also necessary to identify any termination rights or other rights that may be triggered by a change of control of the target, because a reverse triangular merger does result in a change of control.

NOTE: Counsel should be aware of an unreported decision of the United States District Court for the Northern District of California, *SQL Solutions v Oracle Corp.* (ND Cal 1991) 1991 US Dist Lexis 21097, in which the court held that in a reverse triangular merger, the seller was required to obtain licensor consent to assign a software license agreement. That case has been widely criticized, however, and is not consistent with the majority view.

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§7.20 C. Asset Purchases

The final form of acquisition is through purchase of all or substantially all of the target company's assets. By purchasing assets out of the target company, the acquiring company may avoid acquiring some or all of the target's liabilities. Asset purchase agreements present several unique challenges for intellectual property counsel.

First, it is important to identify and schedule all of the key assets that are being acquired. Counsel often are tempted to use a short-cut definition of the purchased assets, such as "all of the assets and intellectual property owned by the seller or used by the seller in the conduct of the seller's business." Such a broad definition may save the time and effort required to identify and schedule the assets being acquired, but for most transactions this type of description does not give the buyer sufficient information regarding what assets it is acquiring and will need in order to continue operating the seller's business. It also creates the risk of a later dispute concerning whether the buyer actually received all the assets it thought it was acquiring. Moreover, for intellectual property assets, such a generic definition does not give the buyer adequate documentation to perfect its chain of title to key patents, copyright, and trademarks being acquired. Buyer's counsel should ensure at a minimum that there is a schedule of all critical assets that the buyer is acquiring, including in particular all intellectual property assets and all material contracts that are to be assigned. Counsel should also require the seller to identify any restrictions on assignment, and obtain any necessary consents for the assignment of mission-critical contracts to the buyer.

Second, it is important for the asset purchase agreement to identify any liabilities of the seller that will be assumed by the buyer and any excluded liabilities that will remain with the seller. As in the case of purchased assets, it is not sufficient for the agreement to merely recite that any liabilities not expressly assumed shall be excluded. Although such a generic definition of excluded liabilities is beneficial to the buyer as a catchall, to avoid any risk of disputes after closing, buyer's counsel should ensure that known liabilities are expressly identified and scheduled as excluded liabilities. It is typical for asset purchase agreements to expressly exclude liabilities arising before the closing date, including liabilities for breach of contract, intellectual property infringement, tax liabilities, and liabilities to the seller's employees for wages, benefits, or stock options.

Finally, in an asset purchase, unlike a statutory merger, the seller's intellectual property assets will not be transferred to the buyer by operation of law, so it is important to obtain an express assignment from the seller of all intellectual property rights. Counsel should require separate forms of assignment for patents, copyrights, and trademarks to document and record the transfer with the appropriate governmental agency. See chap 8 for further discussion and model forms of intellectual property assignment documents.

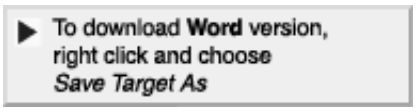
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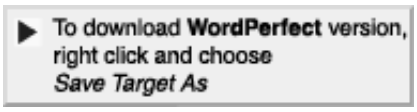
§7.21 V. TYPICAL INTELLECTUAL PROPERTY REPRESENTATIONS AND WARRANTIES

A checklist of intellectual property representations and warranties that buyer's counsel should consider requesting is presented in §7.45. Sections 7.22-7.43 examine certain representations and warranties typically requested by buyers, and review ways in which a seller's counsel might negotiate them to help limit the seller's liability and the risk that the buyer might refuse to close the transaction based on an apparent breach of a representation or warranty.

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§7.22 A. Intellectual Property Definitions





Buyer's counsel often seek a very broad definition of intellectual property and intellectual property rights. Here is a typical "laundry list" of definitions from a negotiated agreement:

"Intellectual Property" means any and all worldwide industrial and intellectual property rights and all rights associated therewith, including all patents and applications therefor and all reissues, divisions, renewals, extensions, provisionals, continuations, and continuations-in-part thereof, all inventions (whether patentable or not), invention disclosures, improvements, trade secrets, proprietary information, know-how, technology, technical data, proprietary processes and formulae, algorithms, specifications, customer lists, and supplier lists, all industrial designs and any registrations and applications therefor, all trade names, logos, common law trademarks and service marks, trademark and service mark registrations and applications therefor, Internet domain names, Internet and World Wide Web URLs or addresses, all copyrights, copyright registrations and applications therefor, and all other rights corresponding thereto, all mask works, mask work registrations and applications therefor, and any equivalent or similar rights in semiconductor masks, layouts, architectures, or topology, all computer software, including all source code, object code, firmware, development tools, files, records and data, all schematics, netlists, test methodologies, test vectors, emulation and simulation tools and reports, hardware development tools, and all rights in prototypes, breadboards, and other devices, all databases and data collections and all rights therein, all moral and economic rights of authors and inventors, however denominated, and any similar or equivalent rights to any of the foregoing, and all tangible embodiments of the foregoing.

"Company IP Rights" means (A) any and all Intellectual Property used in the conduct of the business of the Company and its Subsidiaries as currently conducted or as currently proposed to be conducted by the Company or any Subsidiary; and (B) any and all other Intellectual Property owned by the Company and its Subsidiaries.

"Company-Owned IP Rights" means (A) Company IP Rights that are owned or are purportedly owned by or exclusively licensed to the Company or any of its Subsidiaries; and (B) Company IP Rights that were developed for the Company or a Subsidiary by full- or part-time employees or consultants of the Company or its Subsidiaries (where title to such developed Company IP Rights has not been previously transferred by the Company to a third party).

"Company Registered Intellectual Property" means all United States, international, and foreign: (A) patents and patent applications (including provisional applications); (B) registered trademarks, applications to register trademarks, intent-to-use applications, or other registrations or applications related to trademarks; (C) registered Internet domain names; (D) registered copyrights and applications for copyright registration; and (E) any other Intellectual Property that is the subject of an application, certificate, filing, registration, or other document issued, filed with, or recorded by any governmental authority owned by, registered by, or filed in the name of the Company or any of its Subsidiaries.

"Third Party Intellectual Property Rights" means any Intellectual Property owned by a third party.

Intellectual property counsel often argue against this "laundry list" approach, maintaining that the definitions should at least distinguish between tangible assets, such as technology products, and intangible intellectual property rights. Those distinctions are especially important in asset purchase transactions, where there may be different tax treatment of tangible and intangible assets. Counsel should consider carefully whether the proposed definitions create a risk of an inadvertent breach of a representation or other adverse consequences. Seller's counsel, in particular, should consider whether the scope of the definitions is appropriate for the seller's business, and negotiate narrower definitions if they pose a risk of inadvertent breach.

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§7.23 B. No Adverse Effect

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As noted in §§7.15-7.19, a merger or acquisition can trigger consent requirements or change of control or other potentially troublesome provisions in the target's contracts. For example, many software and technology license agreements permit the licensor to terminate the agreement on a change of control of the licensee. If the target loses its right to use mission-critical software as a result of the transaction, the loss may seriously impact the buyer's operations after closing. It is therefore important for buyer's counsel to obtain complete disclosure of the target's material contracts, including any terms that present special risks. The adverse effect warranty is designed to achieve that purpose. Following is an example:

The execution and delivery or effectiveness of this Agreement or the performance of the Company's obligations under this Agreement, will not cause the Company to be in breach of any Contract governing any Company IP Rights (the "Company IP Rights Agreements") and the consummation of the transactions contemplated by this Agreement will not result in the modification, cancellation, termination, suspension of, or acceleration of any payments with respect to the Company IP Rights Agreements, or give any party to any Company IP Rights Agreement the right to do any of the foregoing.

Seller's counsel often seek to add a materiality or material adverse effect qualifier to that representation, arguing that the representation should apply only to material contracts, and that the seller should not be in breach if a third party's right to terminate on a change of control does not materially impact the seller's business. Buyer's counsel often counter that the buyer needs complete disclosure of all such rights in order to avoid an inadvertent breach of a particular contract, even if the breach does not have a material adverse effect.

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§7.24 C. Ownership and License

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Buyer's counsel typically seeks a warranty that the seller owns or has a valid right or license to all intellectual property used in the seller's business, such as the following:

The Company (i) owns and has independently developed or acquired, or (ii) has the valid right or license to all Company IP Rights.

Seller's counsel often negotiates for a knowledge qualifier on the ownership and license warranty, arguing that otherwise the warranty could be interpreted as a subtle variation of the noninfringement warranty (see §7.29). If the buyer agrees to permit the seller to knowledge-qualify the noninfringement representation (which buyers are usually hesitant to do), then it is logically consistent to permit a knowledge qualifier on the ownership and license warranty. The reasoning is as follows: "Company IP Rights" is defined broadly as all intellectual property rights used in the seller's business. See §7.22. If the seller is infringing a patent (even one of which it is unaware), then technically it is "using" the patented invention, method, or process in its business without a license. The seller may argue that, to avoid insuring the buyer against patent risks of which the seller is not aware, the seller must knowledge-qualify the ownership and license warranty for the same reasons that it knowledge-qualifies the noninfringement warranty.

Seller's counsel should also negotiate to strike the forward-looking aspect of the definition of "Company IP Rights," *i.e.,* the phrase "as proposed to be conducted." Seller's counsel could argue that the language is overbroad in that it implies that the seller should be liable for breach of the warranty for products in the planning stage that the seller had not yet completed. The seller may have planned to launch a product that would require it to obtain certain components from a third party, but may not yet have obtained such components. Arguably, the seller should not be liable for breach merely because it had not yet completed a product that was very low in priority in its business product plan.

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§7.25 D. Sufficiency

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Another typical but hotly contested warranty is known as the "sufficiency rep." Following is an example:

The Company IP Rights are sufficient for the conduct of the business of the Company as currently conducted and as currently proposed to be conducted by the Company.

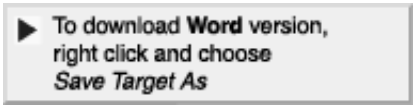
A sufficiency representation is especially important to the buyer in an asset purchase transaction, where the buyer needs assurance that the assets to be purchased are sufficient for the buyer to continue operating the seller's business, and that the seller is not holding back any necessary assets. Counsel often argue that a sufficiency representation is inappropriate in a stock purchase or merger, where the buyer is acquiring an entire company rather than a set of assets, on the grounds that (1) for tangible intellectual property, the sufficiency rep becomes tautological, *i.e.,* the seller is conducting the business, so its tangible assets must be sufficient for it to do so, (2) for intangible intellectual property, a sufficiency representation is merely duplicative of the noninfringement rep, *i.e.,* if the intellectual property rights used in the business are not sufficient, then the seller is infringing a third party's rights.

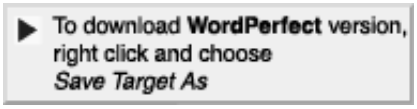
As in the case of the ownership and license warranty discussed in §7.24, seller's counsel often seek to knowledge-qualify the sufficiency rep, arguing that it is another subtle form of noninfringement warranty. If the seller is inadvertently infringing a patent of which it is not aware, so the argument runs, then the intellectual property rights of the seller are not "sufficient" for the operation of the business, because technically the seller should have a license from the patent holder to practice the patented method or process. Here again, if the buyer will allow a knowledge qualifier on the noninfringement warranty, it is logically consistent to allow one on the sufficiency representation.

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Source: Business Law/Intellectual Property in Business Transactions/7 Intellectual Property Issues in Merger and Acquisition Agreements/§7.26 E. Schedule of Registered Intellectual Property

§7.26 E. Schedule of Registered Intellectual Property





It is important for buyer's counsel to obtain a complete docket for any registered intellectual property that the buyer is acquiring, in order to maintain and continue prosecution of the intellectual property assets and to integrate them with the buyer's own portfolio. Following is an example of a seller's warranty regarding a docket or schedule of the seller's intellectual property:

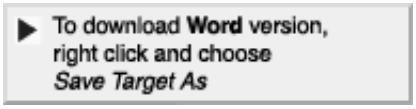
Schedule _ _[*number*]_ _ of the Company Disclosure Letter lists all Company Registered Intellectual Property, including the jurisdictions in which each such item of Intellectual Property has been issued or registered or in which any application for such issuance and registration has been filed, or in which any other filing or recordation of such item of Intellectual Property has been made. Schedule _ _[*number*]_ _ of the Company Disclosure Letter sets forth a list of all actions that are required to be taken by the Company or its Subsidiaries within 120 days of the Agreement Date with respect to any of the Company Registered Intellectual Property in order to avoid prejudice to, impairment of, or abandonment of such Company Registered Intellectual Property.

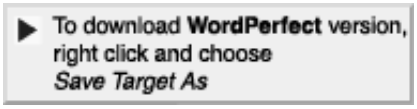
Seller's counsel often objects to the second sentence of this representation, arguing that the seller should not be obligated to generate a list of actions that must be taken and should not be subject to liability if it inadvertently leaves something off the list. Buyer's counsel usually counters that the registered intellectual property is a significant part of the value that the buyer is paying for, and that the buyer cannot afford the risk that any valuable intellectual property assets will lapse or expire during the transition period.

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§7.27 F. Schedule of Inbound Licenses and Royalties





Buyer's counsel should seek complete disclosure of any contracts to which the seller is a party and under which the seller licenses software, technology, or intellectual property from any third parties, together with the amount of any royalties that the seller pays to such third parties. Excessive dependence on third party technology and components may have a significant impact on the value of the seller's business and its products, so buyer's counsel typically insists on a representation such as the following:

Schedule _ _[*number*]_ _ of the Seller Disclosure Letter identifies any continuing Contract for the purchase or in-license by the Company of materials, supplies, equipment, services, software, Intellectual Property, or other assets. Except as set forth in Schedule _ _[*number*]_ _, there are no royalties, honoraria, fees, or other payments payable by the Company or any of its Subsidiaries to any Person (other than salaries payable to employees, consultants, and independent contractors not contingent on or related to use of their work product) as a result of the ownership, use, possession, in-license, out-license, sale, marketing, advertising, or disposition of any Company IP Rights by the Company.

Seller's counsel often pushes for a materiality qualifier on this representation, or alternatively a specific dollar threshold, in order to reduce its scheduling burden.

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§7.28 G. No Pending or Threatened Infringement Claims by Third Parties

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Buyer's counsel should seek complete disclosure and a representation from the seller concerning any infringement claims by, or patent notices from, third parties, as in the following example:

The Company has not received notice of any suit, action, or proceeding, or any threat of any suit, action, or proceeding that involves a claim of infringement or misappropriation of any Intellectual Property right of any third party or which contests the validity, ownership, or right of the Company to exercise any Intellectual Property right. The Company has not received any written or oral communication that involves an offer to license or grant any other rights or immunities under any third party's Intellectual Property rights.

Because technology companies receive so many patent notice letters and offers to license patents that do not give rise to actual patent claims or litigation, seller's counsel often seeks to time-limit the representation to a designated recent time period, *e.g.,* "within the 2 years prior to the effective date." Depending on the context, buyer's counsel can sometimes safely agree to such a qualification. Buyer's counsel should, however, obtain all correspondence regarding any patent notices and confirm that the seller has obtained reliable opinions of counsel that the seller does not infringe. If there are potential issues, buyer's counsel may wish to require a special indemnity. Further, buyer's counsel may require that the seller pay for a separate opinion of counsel for the buyer, in order to help protect the buyer from any claims of willful infringement.

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§7.29 H. Noninfringement by Seller

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Following is a typical warranty that the seller's business operations do not infringe any intellectual property of third parties:

The operation of the business of the Company as such business is currently conducted and as currently proposed to be conducted, including (i) the design, development, manufacturing, reproduction, marketing, licensing, sale, offer for sale, importation, distribution, provision, or use of any Company Product, and (ii) the Company's use of any product, device, or process used in the business of the Company as currently conducted and as currently proposed to be conducted by the Company, does not and will not infringe or misappropriate the Intellectual Property of any third party.

As discussed in §7.12, seller's counsel often seeks a knowledge qualifier on the noninfringement representation, but buyer's counsel should object on the grounds that such a qualifier essentially "guts" the warranty. The seller will of course disclose any infringement issues of which it has knowledge, and the buyer will therefore have no remedy for infringement claims if it accepts the knowledge qualifier. Seller's counsel should also consider language that limits the noninfringement representation to infringement of patents that have issued as of the closing date, and further consider adding a material adverse effect qualifier. Here is how seller's counsel might redline the noninfringement clause above:

Except as would not have a material adverse effect on the operations of the Company, to the knowledge of the Company, the operation of the business of the Company as such business is currently conducted, ~~and as currently proposed to be conducted,~~ including (i) the design, development, manufacturing, reproduction, marketing, licensing, sale, offer for sale, importation, distribution, provision, and/or use of any Company Product, and (ii) the Company's use of any product, device, or process used in the business of the Company as currently conducted ~~and as currently proposed to be conducted~~ by the Company, does not and will not infringe or misappropriate the Intellectual Property of any third party that is issued and effective as of the closing date.

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§7.30 I. Noninfringement by Third Parties

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Buyer's counsel should obtain complete disclosure from the seller regarding any infringement of the seller's intellectual property by any third parties, including in particular any infringement actions brought by the seller itself. Buyers are often willing to knowledge-qualify this representation from the start. Following is an example of a seller's warranty (with a knowledge qualifier) of noninfringement by third parties of the seller's intellectual property:

To the knowledge of the Company, there is no unauthorized use, unauthorized disclosure, infringement, or misappropriation of any Company-Owned IP Rights by any third party, including any employee or former employee of the Company. The Company has not brought any action, suit, or proceeding for infringement or misappropriation of any Intellectual Property or breach of any Company IP Rights Agreement against any third party.

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§7.31 J. Employee and Consultant Invention Assignments

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One objective of buyer's counsel, especially in technology industry transactions, is to confirm that the seller can document an adequate chain of title to all of its intellectual property assets. Buyer's counsel therefore often requires that the seller produce invention assignment agreements from all employees and independent contractors who have contributed to the creation of those assets. If the seller does not have or cannot find such invention assignment agreements, buyer's counsel typically requires the seller to obtain confirmatory assignments. Often, the seller will have obtained invention assignment agreements from employees, but the founders themselves have not yet assigned their rights to the company, so it will be necessary to obtain confirmatory assignments from the founders. For further discussion of invention assignment agreements and sample forms, see §§8.15-8.17.

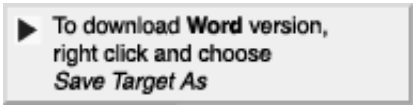
Following is an example of a seller's warranty concerning invention assignments:

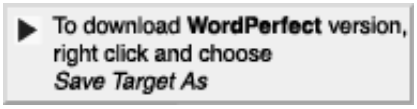
The Company has secured from all of its consultants, employees, and independent contractors who independently or jointly contributed to the conception, reduction to practice, creation, or development of any Company-Owned IP Rights unencumbered and unrestricted exclusive ownership of all such third party's Intellectual Property in such contribution. Without limiting the foregoing, the Company has obtained proprietary information and invention disclosure and assignment agreements from all current and former employees, consultants, and independent contractors of the Company.

Seller's counsel often seek a knowledge qualifier on this warranty, but buyer's counsel should argue that the risk of claims should be born by the seller, whether or not the seller is aware of any issues. In the author's experience, this warranty is among the ones most frequently raised by buyers in their postclosing indemnity claims. All too often, after a transaction has been announced, a former employee or founder of a company claims that he or she owns a part of the company's intellectual property or that he or she had been promised but did not receive consideration in exchange for an assignment.

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§7.32 K. Contracts Restricting Operation of Business





Buyer's counsel should ensure that it has received complete disclosure of any contracts that restrict the conduct of the seller's business, such as contracts granting any exclusivity to third parties or contracts that include any sort of "most favored nation" pricing commitments (*i.e.,* commitments that the price extended to a given customer will be at least as low as the price extended to any other customer). Following is an example of a warranty regarding contracts that restrict the seller's business operations:

Section _ _[*number*]_ _ of the Seller's Disclosure Letter identifies any Contract limiting the freedom of the Company to engage or participate, or compete with any other Person, in any line of business, market, or geographic area, or any Contract granting most favored nation pricing, exclusive sales, distribution, marketing, or other exclusive rights, rights of refusal, rights of first negotiation, or similar rights or terms to any Person, or any Contract otherwise limiting the right of the Company to sell, distribute, or manufacture any products or services or to purchase or otherwise obtain any software, components, parts, subassemblies, or services.

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§7.33 L. Government Funding; University Affiliations

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Buyer's counsel should also confirm that the seller has disclosed any government funding that the seller has received. Often, a government grant comes with restrictions on sale or use of products developed with the grant, and government funding can result in claims that the government owns or has unlimited rights to products or technology developed with such funds. Similarly, buyer's counsel should obtain complete disclosure regarding any university grants used to develop the seller's products and any affiliations that the founders or other contributors may have had with universities. Faculty in particular often have contracts with their universities providing that the university owns all intellectual property developed by faculty members during their employment. See §§8.26-8.30 for further discussion of these issues. A form of patent license agreement from a university is presented in §8.27.

Following is a typical warranty intended to elicit full disclosure of any government funding or university affiliations:

No (i) government funding, (ii) facilities of a university, college, other educational institution or research center, or (iii) funding from any Person (other than funds received in consideration for the Company Capital Stock) was used in the development of the Company-Owned IP Rights. No current or former employee, consultant, or independent contractor of the Company or any Subsidiary who was involved in, or who contributed to, the creation or development of any Company-Owned IP Rights has performed services for any government, university, college, or other educational institution or research center during a period of time during which such employee, consultant, or independent contractor was also performing services for the Company.

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§7.34 M. Open Source Software

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Especially in the technology sector, the widespread use of "open source" software presents significant intellectual property risks. Several open source licenses, including the Free Software Foundation's GNU General Public License (GPL) (see §8.31), require as a condition of the license that any user who integrates open source software into any software that they distribute must license the entire work (including the user's own proprietary software) as open source under the terms of the license. Sellers often fail to understand the implications of that condition and integrate software licensed under the GPL with their own proprietary software, posing the risk that they will either be guilty of copyright infringement or be forced to make the proprietary source code for their software available to the public. For further discussion of this issue, see §8.31.

Buyer's counsel should obtain complete disclosure concerning the seller's use of any open source software, and a warranty and indemnification against the risks presented by such use. Following is an example of such a warranty:

Schedule _ _[*number*]_ _ of the Company Disclosure Letter lists all software or other material that is distributed as "free software," "open source software," or under similar licensing or distribution terms (including but not limited to the GNU General Public License (GPL), GNU Lesser General Public License (LGPL), Mozilla Public License (MPL), BSD licenses, the Artistic License, the Netscape Public License, the Sun Community Source License (SCSL), the Sun Industry Standards License (SISL), and the Apache License) ("Open Source Materials") used by the Company in any way, and describes the manner in which such Open Source Materials were used, including whether (and, if so, how) the Open Source Materials were modified or distributed by the Company. The Company is in compliance with the terms and conditions of all applicable licenses for the Open Source Materials.

The Company has not (i) incorporated Open Source Materials into, or combined Open Source Materials with, the Company IP Rights or Company Products; (ii) distributed Open Source Materials in conjunction with any Company IP Rights or Company Products; or (iii) used Open Source Materials in each case in such a way that creates obligations for the Company with respect to any Company IP Rights or grant to any third party any rights or immunities under any Company IP Rights, including any obligation that other software incorporated into, derived from, or distributed with such Open Source Materials be (A) disclosed or distributed in source code form, (B) be licensed for the purpose of making derivative works, or (C) be redistributable at no charge.

Seller's counsel often seeks to knowledge-qualify the open source representation, arguing that the seller's management may not be aware of what the seller's engineers have done, and further that it is not clear under the terms of the GPL or other open source licenses whether the seller would be obligated to make any of its proprietary software available as open source. Buyer's counsel usually counters that any risk should be born by the seller.

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§7.35 N. No Prior Sale of Intellectual Property

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It is important for buyer's counsel to determine whether the seller has sold any of its intellectual property, to ensure that the buyer obtains all of the intellectual property that it believes it is purchasing. Following is an example of a warranty that the seller has not previously transferred any of the intellectual property rights to be acquired by the buyer:

The Company has not transferred ownership of any Intellectual Property that is or was Company-Owned IP Rights to any third party, or knowingly permitted the Company's rights in any Intellectual Property that is or was Company-Owned IP Rights to enter the public domain.

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§7.36 O. Validity of Registered Intellectual Property

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Especially when patents or trademarks are an important part of the value of a transaction, buyer's counsel often seek a specific representation that the seller has adequately maintained all of its registered intellectual property, such as the following:

Each item of Company Registered Intellectual Property (other than applications) is valid and subsisting (or in the case of applications, applied for); all registration, maintenance, and renewal fees currently due in connection with such Company Registered Intellectual Property have been paid; and all documents, recordations, and certificates in connection with such Company Registered Intellectual Property currently required to be filed have been filed with the relevant patent, copyright, trademark, or other authorities in the United States or foreign jurisdictions, as the case may be, for the purposes of prosecuting, maintaining, and perfecting such Company Registered Intellectual Property and recording the Company's and its Subsidiaries' ownership interests therein.

Although patents are presumptively valid (see 35 USC §282), seller's counsel often objects to making a representation that the seller's patents are "valid" because the validity of a patent is never conclusively established until a final adjudication of the issue in litigation proceedings. Seller's counsel argues that the seller should not be placed in a position where it would be in breach of warranty if after closing the buyer decides to take the risk of asserting one of the seller's patents in an infringement action but the court holds that the patent is invalid. Buyer's counsel often counters that the seller should warrant the validity of the patents because the patents are part of the value that seller is being compensated for. The parties often compromise by permitting the seller to knowledge-qualify the validity representation.

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§7.37 P. No Encumbrances

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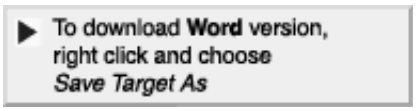
Especially in the technology sector, it is not uncommon for a company to pledge its intellectual property assets as collateral to secure a credit line. (Intellectual property in secured lending transactions is discussed in depth in chap 9.) It is therefore important for the buyer to obtain a warranty that there are no security interests or other encumbrances affecting the seller's intellectual property. Following is an example of such a warranty:

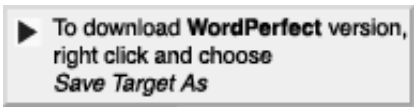
The Company owns and has good and exclusive title to each item of Company-Owned IP Rights and each item of Company Registered Intellectual Property, free and clear of any Encumbrances.

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Source: Business Law/Intellectual Property in Business Transactions/7 Intellectual Property Issues in Merger and Acquisition Agreements/§7.38 Q. Opinion of Counsel Regarding Infringement

§7.38 Q. Opinion of Counsel Regarding Infringement





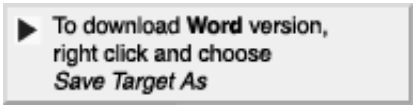
Companies often learn of potential patent infringement issues from their own engineers or internal counsel, and it is useful for the buyer to ensure that the seller has disclosed any opinion of counsel regarding infringement issues. Following is an example of a warranty that the seller has not received any opinion of counsel that the subject intellectual property infringes any third party rights:

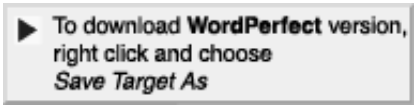
The Company has not received any opinion of counsel that any Company Product or the operation of the business of the Company, as previously or currently conducted, or as currently proposed to be conducted by the Company, infringes or misappropriates any Third Party Intellectual Property Rights.

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Source: Business Law/Intellectual Property in Business Transactions/7 Intellectual Property Issues in Merger and Acquisition Agreements/§7.39 R. Protection of Trade Secrets and Other Confidential Information

§7.39 R. Protection of Trade Secrets and Other Confidential Information





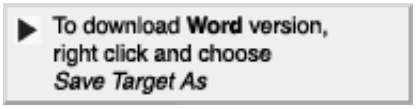
Because a significant part of the value of a company may lie in its trade secrets and other confidential information, buyer's counsel typically seeks a warranty that the seller has taken reasonable measures to protect its trade secrets and other confidential information, such as the following:

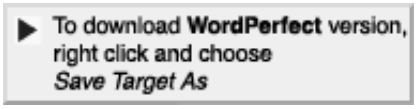
The Company has taken all reasonable steps to protect and preserve the confidentiality of all confidential or nonpublic information included in the Company IP Rights ("Confidential Information"). All use, disclosure, or appropriation of Confidential Information owned by the Company by or to a third party has been pursuant to the terms of a written Contract between the Company and such third party.

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Source: Business Law/Intellectual Property in Business Transactions/7 Intellectual Property Issues in Merger and Acquisition Agreements/§7.40 S. Membership in Standards Organizations

§7.40 S. Membership in Standards Organizations



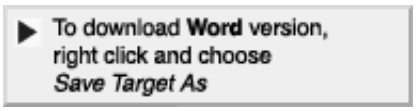


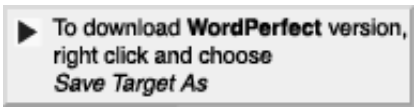
Standards bodies and other trade associations play an increasingly important role in nearly every industry. The membership agreements for such organizations sometimes include intellectual property provisions that may require participants to assign intellectual property rights to the organization or agree in advance to license certain patent rights to anyone who practices an issued standard. Buyer's counsel should therefore obtain complete information regarding any such organizations in which the seller participates and a warranty from the seller, such as the following, that it has no obligations to any such standards organization.

The Company is not now nor has ever been a member or promoter of, or a contributor to, any industry standards body or any similar organization that requires or obligates the Company to grant or offer to any other Person any license or right to any Company-Owned IP Rights.

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§7.41 T. Compliance With Customer Warranties





Buyer's counsel should ensure that it obtains a warranty from the seller that the seller's products conform to all applicable contractual commitments and warranties. This is an important risk allocation provision, because the buyer will want recourse against the escrow account, if applicable (see §7.8), for any warranty claims from customers arising after the closing. Following is an example of a seller's warranty that its products comply with applicable customer warranties and contractual commitments:

All Company Products sold, licensed, leased, or delivered by the Company to customers and all services provided by or through the Company to customers on or prior to the Closing Date conform in all material respects to applicable contractual commitments and express and implied warranties, and conform in all material respects to packaging, advertising, and marketing materials and to applicable product or service specifications or documentation.

For discussion of how a seller may seek to add a materiality or material adverse effect qualifier to this representation, see §7.13.

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§7.42 U. Compliance With Privacy Laws

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Data security is an increasingly important source of potential liability for modern businesses. Buyer's counsel should therefore ensure that the seller warrants that it is in material compliance with all applicable privacy laws and internal privacy policies. Following is an example of a seller's warranty regarding privacy law compliance.

The Company has complied with all applicable Legal Requirements and its internal privacy policies relating to the use, collection, storage, disclosure, and transfer of any personally identifiable information collected by the Company or by third parties having authorized access to the records of the Company.

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§7.43 V. Source Code Escrows

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For traditional (*i.e.,* not open source) software companies, source code is often among their most valuable assets, and any disclosure of the source code could significantly undermine the company's value. Buyer's counsel often seeks a warranty regarding any prior disclosures of source code and any agreements that require the seller to place source code into an escrow for the benefit of the seller's customers or secured lenders. Following is an example of such a warranty:

The Company has not disclosed, delivered, or licensed to any Person, agreed to disclose, deliver, or license to any Person, or permitted the disclosure or delivery to any escrow agent or other Person of, any Company Source Code. No event has occurred, and no circumstance or condition exists, that (with or without notice or lapse of time, or both) will, or would reasonably be expected to, result in the disclosure, delivery, or license by the Company to any Person of any Company Source Code.

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§7.44 VI. CONCLUSION: KEEPING INTELLECTUAL PROPERTY ISSUES IN PERSPECTIVE

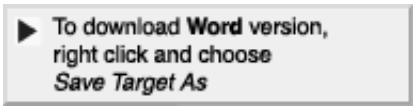
Intellectual property issues play an increasingly central role in mergers and acquisitions. Even outside of the technology sector—*e.g.,* in energy, transportation, health, and even food processing industry transactions—intellectual property assets make up an important part of a company's value. Companies depend on licenses to third party software and technology for their continuing operations. Intellectual property infringement claims are among the greatest threats faced by modern business enterprises. Yet, although intellectual property issues are critical, they are only one piece of the overall puzzle that must come together to complete a complex merger or acquisition. Securities, tax, and employment considerations are often just as likely to drive the pace and structure of the transaction. For further discussion of these considerations, see Sales and Mergers of California Businesses (Cal CEB 2002).

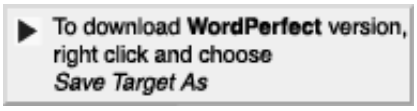
Intellectual property counsel can best serve their clients by managing the intellectual property aspects of the transaction on a separate but parallel track. By being thoroughly familiar with the entire agreement and its structure (especially liability caps, closing conditions, and indemnification escrow provisions), and also focusing independently on proper drafting and negotiation of intellectual property provisions, intellectual property counsel on both sides can best protect the intellectual property interests of their clients. By developing expertise in the intellectual property aspects of mergers and acquisitions, intellectual property attorneys can add significant value to these highly complex and interesting transactions, and build for themselves a rewarding and interesting facet of their intellectual property practice.

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Source: Business Law/Intellectual Property in Business Transactions/7 Intellectual Property Issues in Merger and Acquisition Agreements/§7.45 VII. CHECKLIST OF TYPICAL INTELLECTUAL PROPERTY REPRESENTATIONS AND WARRANTIES

§7.45 VII. CHECKLIST OF TYPICAL INTELLECTUAL PROPERTY REPRESENTATIONS AND WARRANTIES





- 1. Intellectual Property Definitions (§7.22)
- 2. No Adverse Affect (§7.23)
- 3. Ownership and License (§7.24)
- 4. Sufficiency (§7.25)
- 5. Schedule of Registered Intellectual Property and Actions to Be Taken (§7.26)
- 6. Schedule of Inbound Licenses and Royalties (§7.27)
- 7. No Infringement Claims by Third Parties (§7.28)
- 8. Noninfringement by Seller (§7.29)
- 9. Noninfringement by Third Parties (§7.30)
- 10. Employee and Consultant Invention Assignments (§7.31)
- 11. Contracts Restricting Operation of the Business (§7.32)
- 12. Government Funding; University Affiliations (§7.33)
- 13. Open Source Software (§7.34)
- 14. No Prior Sale of Intellectual Property (§7.35)
- 15. Validity of Registered Intellectual Property (§7.36)
- 16. No Encumbrances (§7.37)
- 17. Opinion of Counsel Regarding Infringement (§7.38)
- 18. Protection of Confidential Information (§7.39)
- 19. Membership in Standards Organizations (§7.40)
- 20. Compliance With Customer Warranties (§7.41)
- 21. Compliance With Privacy Laws (§7.42)
- 22. Source Code Escrows (§7.43)

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8

Related Documents

Stuart P. Meyer

I. INTRODUCTION §8.1

II. INTERCOMPANY CONFIDENTIALITY AGREEMENT
- A. Introduction §8.2
- B. Form: Intercompany Confidentiality Agreement §8.3

III. INTELLECTUAL PROPERTY ASSIGNMENT DOCUMENTS
- A. Introduction §8.4
- B. Patent Assignments
  - 1. Introduction §8.5
  - 2. Form: Patent Assignment §8.6
  - 3. Form: Patent Cover Sheet §8.7
- C. Trademark Assignments With Goodwill
  - 1. Introduction §8.8
  - 2. Form: Trademark and Goodwill Assignment §8.9
  - 3. Form: Trademark Cover Sheet §8.10
- D. Copyright Assignments
  - 1. Introduction §8.11
  - 2. Form: Basic Copyright Assignment §8.12
  - 3. Form: Assignment for Software §8.13
  - 4. Form: U.S. Copyright Office Cover Sheet §8.14
- E. Employee and Independent Contractor Invention Assignments and Confidentiality Agreements
  - 1. Introduction §8.15
  - 2. Form: Employee Confidentiality and Proprietary Rights Agreement §8.16
  - 3. Form: Independent Contractor Confirmatory Assignment and License Agreement §8.17
- F. Forms Used for Transfer of Internet Domains
  - 1. Introduction §8.18
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§8.1 I. INTRODUCTION

In addition to the merger or acquisition agreement discussed in chap 7, the parties to a merger or acquisition transaction that features intellectual property may negotiate and sign numerous ancillary agreements and other documents both before, and in connection with, the closing of the transaction. An acquiring company undertaking due diligence review generally signs a confidentiality agreement before starting its investigation of the target's business and assets. Such confidentiality agreements are discussed in §§8.2-8.3. Apart from the corporate documents normally associated with the closing of a merger or acquisition, and depending on the structure and terms of the transaction, closing documents may include assignments of intellectual property rights and the corresponding recordation of such assignments (see §§8.4-8.14), employee and independent contractor invention assignments (see §§8.15-8.17), transfer documents for Internet domain names (see §§8.18-8.20), transition services agreements (see §§8.21-8.22), various types of licenses (see §§8.23-8.32), and legal opinions (see §8.33). If the buyer is financing part of the purchase price in a secured transaction with an institutional lender, the closing documents will also include financing and security documents, which are discussed in chap 9.

Other ancillary agreements (which are beyond the scope of this book) may include: development agreements, under which the seller provides technology development assistance to the buyer after closing if the seller has special expertise that the buyer lacks; service agreements, if the seller can provide a special service or process to the buyer cost-effectively after closing; and supply or distribution agreements, if the parties wish to enter into a long-term arrangement for supply of materials or components or distribution of manufactured products.

If the target company's assets include unregistered copyrights, the acquiring company may wish to register them soon after closing. Copyright registration is discussed in §§8.34-8.35.

A model closing list of documents for an asset acquisition is presented in §8.36.

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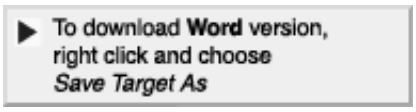
II. INTERCOMPANY CONFIDENTIALITY AGREEMENT

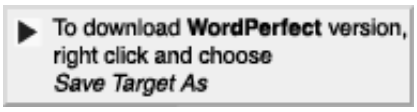
§8.2 A. Introduction

Many business transactions start with a confidentiality agreement intended to allow the parties to discuss matters pertinent to the transaction in more detail than they would want to provide in a public discussion. One example of such an agreement is provided in §8.3.

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§8.3 B. Form: Intercompany Confidentiality Agreement





8.3-1 Intercompany confidentiality agreement

CONFIDENTIALITY AGREEMENT

This Confidentiality Agreement (this "Agreement") is entered into as of _ _[*date*]_ _, between _ _[*name of company*]_ _ (the "Company"), and _ _[*name of company*]_ _ (the "AcquiringCo").

1. *Purpose.* The parties wish to explore a business opportunity and, in connection with this opportunity, the Company may disclose to the AcquiringCo certain confidential technical and business information, including, but not limited to, information concerning a possible acquisition (the "Transaction") by AcquiringCo of certain assets of the Company, that the Company and AcquringCo desire to treat as confidential.

2. *Confidentiality of Information*.

2.1. The AcquiringCo (i) shall keep the Information (as defined below) confidential and shall not (except as required by applicable law or legal process), without the Company's prior written consent, disclose to any person any Information, and (ii) shall not use any Information in any manner (whether for itself, any other person, or otherwise) other than solely in connection with the Transaction. In addition, the AcquiringCo shall take all reasonable actions and precautions to prevent the disclosure, use, copying, duplicating, or reproducing of any Information, as well as any information the disclosure of which is limited by the provisions of Section 3 below, in any manner contrary to the provisions of this Agreement.

2.2. The term "Information" shall mean, with respect to the Company or the AcquiringCo, the confidential, proprietary, or nonpublic information, including without limitation information relating to the Transaction (whether furnished before or after the date of this Agreement and whether written, oral, electronic, or otherwise), furnished by the Company to the AcquiringCo. The term "Information" shall not, however, include information that (i) is or becomes publicly available other than as a result of a disclosure by the AcquiringCo in violation of this Agreement, (ii) is or becomes available to the AcquiringCo on a nonconfidential basis from a source (other than the Company) that, to the AcquiringCo's knowledge, is not prohibited from disclosing such information to the AcquiringCo, (iii) is known to the AcquiringCo prior to disclosure by the Company, (iv) is or has been independently developed by the AcquiringCo without use of any information furnished to it by the Company, or (v) is transmitted by a party after delivery of written notice by the other party that it no longer wishes to receive the Information hereunder.

3. *Confidentiality of Transaction and Transaction Status.* Without the prior written consent of the Company, the AcquiringCo shall not (except as required by applicable law or legal process) disclose to any person any information regarding a possible Transaction or any information relating in any way to the Information, including without limitation (i) that any investigations, discussions, or negotiations are taking or have taken place concerning a possible Transaction, including the status thereof or the termination of such discussions or negotiations, (ii) any of the terms, conditions, or other facts with respect to any such possible Transaction or consideration of a possible Transaction, (iii) that this Agreement exists, that Information exists or has been requested or made available, or (iv) any opinion or view with respect to the Transaction or the Information. The AcquiringCo further agrees that it will disclose the information described in this paragraph only to those who have a need to know such information, are informed of the confidential nature of the information, and agree to be bound by the terms of this Agreement, and that such disclosure will be made solely for the purpose of evaluating or assisting with the Transaction.

4. *Return of Information.* On written request of the Company, the AcquiringCo shall promptly return to the Company all Information that has been provided to the AcquiringCo, and no copies, extracts, or other reproductions of the Information shall be retained by the AcquiringCo.

5. *No Obligation.* Nothing herein shall obligate any party to proceed with any business opportunity between any of them, and each party reserves the right, in its sole discretion, to terminate the discussions contemplated by this Agreement concerning the business opportunity.

6. *No Representations Concerning the Accuracy of the Information.* The AcquiringCo acknowledges that the Company does not make any express or implied representation or warranty concerning the accuracy or completeness of the Information. The AcquiringCo agrees that it will be entitled to rely only on such representations and warranties as may be included in definitive agreements (if any) with respect to the Transaction, subject to such limitations and restrictions as may be contained therein.

7. *No License.* Nothing in this Agreement is intended to grant any rights to the AcquiringCo under any patent, copyright, trade secret, or other intellectual property right, nor shall this Agreement grant the AcquiringCo any rights in or to the Company's or AcquiringCo's Information except as expressly set forth herein.

8. *Miscellaneous.*

8.1. *Injunctive Relief.* The AcquiringCo agrees that its obligations hereunder are necessary and reasonable in order to protect the Company and its business, and expressly agrees that monetary remedies would be inadequate to compensate the Company for any actual or threatened breach of this Agreement by the AcquiringCo. Accordingly, the AcquiringCo acknowledges and agrees that any such violation or threatened violation will cause irreparable injury to the Company and that, in addition to any other rights and remedies otherwise available to the Company, the Company will be entitled to obtain injunctive relief and specific performance, without proof of actual damages and without any need to secure or post any bond in connection therewith.

8.2. *Severability.* If any provision of this Agreement shall, for any reason, be adjudged by any court of competent jurisdiction to be invalid or unenforceable, such judgment shall not affect, impair, or invalidate the remainder of this Agreement but shall be confined in its operation to the provision of this Agreement directly involved in the controversy in which such judgment shall have been rendered.

8.3. *Successors and Assigns.* This Agreement shall be binding on, and shall inure to the benefit of, the parties hereto and their respective successors and assigns.

8.4. *Modifications to Agreement; Waivers.* No modifications of or changes to this Agreement or waiver of the terms and conditions hereof shall be binding on the Company or the AcquiringCo, unless approved in writing and signed by both the Company and the AcquiringCo. It is further agreed that no failure or delay in exercising any right, power, or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any right, power, or privilege hereunder.

8.5. *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of California, without regard to its conflicts-of-laws principles.

8.6. *Termination.* The obligations of each party to this Agreement shall survive until such time as all Information disclosed hereunder becomes publicly known and made generally available through no action or inaction of the AcquiringCo.

8.7. *Entire Agreement.* This Agreement constitutes the full and entire understanding and agreement between the parties with regard to the subject matter of this Agreement and supersedes all prior negotiations, understandings, and agreements with respect thereto.

8.8. *Notices.* Any notice required or permitted to be given by a party under this Agreement shall be delivered by hand, overnight courier, or confirmed facsimile to the person who executes this Agreement for the other party, at the address provided below for such person.

8.9. *Counterparts.* This Agreement may be executed in any number of counterparts, each of which shall be an original, but all of which together shall constitute one instrument.

IN WITNESS WHEREOF, the parties have caused this Confidentiality Agreement to be executed and delivered as of the date first written above.

Date: _ _ _ _ _ _

Company:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _
_ _[*Address*]_ _

Date: _ _ _ _ _ _

AcquiringCo:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _
_ _[*Address*]_ _

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III. INTELLECTUAL PROPERTY ASSIGNMENT DOCUMENTS

§8.4 A. Introduction

Federal copyright and patent statutes and federal and state trademark statutes all require assignments of the subject intellectual property to be in writing. The copyright statute, for example, provides (17 USC §204(a)):

> A transfer of copyright ownership, other than by operation of law, is not valid unless an instrument of conveyance, or a note or memorandum of the transfer, is in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent.

See also 35 USC §261 (patents); 15 USC §1060(a) (federal trademarks); Bus & P C §14220 (state trademarks). In theory, trade secrets can be validly conveyed by one party to another without a writing, although oral assignments are subject to the usual limitations of oral contracts, notably the statute of frauds (see CC §§1624-1624.5), and in general present such problems of enforceability that they are never advisable. Accordingly, the parties to asset purchase and sale transactions involving intellectual property execute assignment documents at the closing to accomplish the actual transfer of ownership of intellectual property rights from the seller to the buyer. Model forms of patent, trademark, and copyright assignments are provided in §§8.5-8.14.

Intellectual property assignments are also typically included in employee and independent contractor agreements to clarify that the employing company owns all intellectual property created under the agreements. Sometimes, employee and independent contractor agreements are expressly referenced in IP-related transactional documents, *e.g.,* in connection with representations and warranties of the selling company that its employees and independent contractors have all signed such agreements. Whenever the agreements cannot be located or if they appear incomplete, out of date, or otherwise insufficient, it is common for confirmatory assignment documents to be executed in connection with the main transaction—regardless of how it is structured—to ensure that all legal rights are properly conveyed to the appropriate entity. Examples of employee and independent contractor assignment agreements are presented in §§8.15-8.17. The sample independent contractor agreement in §8.17 also includes a license to any part of the contractor's "background" technology that may be included in the contractor's deliverables to the company.

Forms appropriate for transfer of internet domain names are discussed in §§8.18-8.20.

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B. Patent Assignments

§8.5 1. Introduction

In many transactions involving technology companies, the primary form of intellectual property to be transferred consists of patent rights. Separate written patent assignment documents are necessary whenever patents or patent applications are included in an acquisition of all or part of the assets of a seller. For complete protection of rights, patent assignments must be recorded in the U.S. Patent and Trademark Office (PTO). See generally 35 USC §261. The recording requirements are set forth in 37 CFR §§3.1-3.41.

Further, if due diligence for a merger or acquisition reveals that an assignment was never obtained from an employee-inventor, a patent-specific form of assignment may be used to ensure that the company perfects its title in the patent or application. Normally, a patent assignment is obtained from an employee at or about the time that a patent application is filed, because without such an assignment legal ownership in the patent application generally remains with the individual inventor rather than the company employer. An employee may, of course, be bound by his or her employment agreement to transfer patent rights to the company, but until that is accomplished, legal title will be held by the individual inventor.

Finally, due diligence may reveal a break in the chain of title to a patent, *e.g.,* if an acquired company never formally transferred its patent rights to the acquiring entity, and this may need to be corrected in connection with the closing of the transaction.

An example of a patent assignment that can be used for all of these purposes is provided in §8.6. The patent assignment should identify the patent by number and date, and also include the inventor and the title of the invention. A cover sheet as prescribed by the PTO is required to be filed along with the assignment document. A copy of the cover sheet is reproduced in §8.7, and is available for downloading at http://www.uspto.gov/web/forms/pto1595.pdf.

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.6 2. Form: Patent Assignment

§8.6 2. Form: Patent Assignment

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8.6-1 Patent assignment

PATENT ASSIGNMENT

For good and valuable consideration, receipt of which is hereby acknowledged, _ _[*name of assignor*]_ _, a _ _[*e.g., California*]_ _ corporation having a place of business at _ _[*address*]_ _ ("Assignor"), has assigned and transferred and does hereby assign and transfer to _ _[*name of assignee*]_ _, a _ _[*e.g., Delaware*]_ _ corporation having a place of business at _ _[*address*]_ _ ("Assignee"), the entire right, title and interest in and to the following identified Letters Patent ("Letters Patent") and Applications for Letters Patent ("Applications") of the United States:

Patent No.	Title	Issue Date

Application No.	Title	Filing Date

and any and all applications for patent and patents therefor in any and all countries, including all divisionals, reissues, continuations, continuations-in-part, and extensions thereof, and in all inventions set forth and described therein, together with all rights of priority resulting from the filing of the Applications and the issuance of the Letters Patent in the United States, and the right to sue in its own name and to recover for past infringement of any of the Letters Patent**.**

Assignor hereby covenants, warrants, and represents to Assignee that (i) Assignor

[*If the Assignor is an employee of the selling company, the following representation and warranty will not be appropriate and should be omitted. It should be included, however, if the Assignor is not an employee of the selling company.*]

is the sole owner of and has the exclusive right to use the Letters Patent and the Applications, free and clear of any liens, encumbrances, licenses, or claims of any nature, and

[*Continue*]

has made no agreement with respect to the Letters Patent and the Applications that is in conflict with this Assignment, and (ii) except as described above, no other registration has been effected or is on file with the appropriate governmental agencies with respect to the Letters Patent or the Applications.

Assignor agrees, for itself and its successors and assigns, that on request and without further consideration, but at the expense of Assignee, Assignor shall communicate to Assignee or its designated representatives or nominees any facts known to Assignor respecting the Letters Patent, the Applications, and

the inventions set forth therein, and shall testify in any legal proceeding, sign all lawful documents, execute all divisional, continuing, and reissue applications, make all rightful oaths or declarations, and generally do everything possible to aid Assignee, its successors, assigns, and nominees to obtain, maintain, and enforce patent protection in all countries for the inventions set forth in the Letters Patent and the Applications and in all foreign counterparts thereof.

Date: _ _ _ _ _ _

Assignor:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ *[Officer's seal]*

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.7 3. Form: Patent Cover Sheet

§8.7 3. Form: Patent Cover Sheet



Form **PTO-1595** (Rev. 03-09)
OMB No. 0651-0027 (exp. 03/31/2009)

U.S. DEPARTMENT OF COMMERCE
United States Patent and Trademark Office

RECORDATION FORM COVER SHEET
PATENTS ONLY

To the Director of the U.S. Patent and Trademark Office: Please record the attached documents or the new address(es) below.

1. Name of conveying party(ies)

Additional name(s) of conveying party(ies) attached? ☐ Yes ☐ No

2. Name and address of receiving party(ies)

Name: _____

Internal Address: _____

_____

Street Address: _____

_____

City: _____

State: _____

Country: _____ Zip: _____

Additional name(s) & address(es) attached? ☐ Yes ☐ No

3. Nature of conveyance/Execution Date(s):

Execution Date(s) _____

☐ Assignment ☐ Merger
☐ Security Agreement ☐ Change of Name
☐ Joint Research Agreement
☐ Government Interest Assignment
☐ Executive Order 9424, Confirmatory License
☐ Other _____

4. Application or patent number(s):

☐ This document is being filed together with a new application.

A. Patent Application No.(s)

B. Patent No.(s)

Additional numbers attached? ☐ Yes ☐ No

5. Name and address to whom correspondence concerning document should be mailed:

Name: _____

Internal Address: _____

_____

Street Address: _____

_____

City: _____

State: _____ Zip: _____

Phone Number: _____

Fax Number: _____

Email Address: _____

6. Total number of applications and patents involved: _____

7. Total fee (37 CFR 1.21(h) & 3.41) $_____

☐ Authorized to be charged to deposit account
☐ Enclosed
☐ None required (government interest not affecting title)

8. Payment Information

Deposit Account Number _____

Authorized User Name _____

9. Signature:

_____ _____
Signature Date

_____
Name of Person Signing

Total number of pages including cover sheet, attachments, and documents: ☐

Documents to be recorded (including cover sheet) should be faxed to (571) 273-0140, or mailed to:
Mail Stop Assignment Recordation Services, Director of the USPTO, P.O.Box 1450, Alexandria, V.A. 22313-1450

Print

Guidelines for Completing Patents Cover Sheets (PTO-1595)

Cover Sheet information must be submitted with each document to be recorded. If the document to be recorded concerns both patents and trademarks separate patent and trademark cover sheets, including any attached pages for continuing information, must accompany the document. All pages of the cover sheet should be numbered consecutively, for example, if both a patent and trademark cover sheet is used, and information is continued on one additional page for both patents and trademarks, the pages of the cover sheet would be numbered from 1 to 4.

Item 1. Name of Conveying Party(ies).

Enter the full name of the party(ies) conveying the interest. If there is insufficient space, enter a check mark in the "Yes" box to indicate that additional information is attached. The name of the additional conveying party(ies) should be placed on an attached page clearly identified as a continuation of the information Item 1. Enter a check mark in the "No" box, if no information is contained on an attached page. If the document to be recorded is a joint research agreement, enter the name(s) of the party(ies) other than the owner of the patent or patent application as the conveying party(ies).

Item 2. Name and Address of Receiving Party(ies).

Enter the name and full address of the first party receiving the interest. If there is more than one party receiving the interest, enter a check mark in the "Yes" box to indicate that additional information is attached. Enter a check mark in the "No" box, if no information is contained on an attached page. If the document to be recorded is a joint research agreement, enter the name(s) of the patent or patent application owner(s) as the receiving party.

Item 3. Nature of Conveyance/Execution Date(s).

Enter the execution date(s) of the document. It is preferable to use the name of the month, or an abbreviation of that name, in order that confusion over dates is minimized. Place a check mark in the appropriate box describing the nature of the conveying document. If the "Other" box is checked, specify the nature of the conveyance.

Item 4. Application Number(s) or Patent Number(s).

Indicate the application number(s), and/or patent number(s) against which the document is to be recorded. National application numbers must include both the series code and a six-digit number (e.g., 07/123,456), and international application numbers must be complete (e.g., PCT/US91/12345).

Enter a check mark in the appropriate box: "Yes" or "No " if additional numbers appear on attached pages. Be sure to identify numbers included on attached pages as the continuation of Item 4. Also enter a check mark if this Assignment is being filed with a new application.

Item 5. Name and Address of Party to whom correspondence concerning the document should be mailed. Enter the name and full address of the party to whom correspondence is to be mailed.

Item 6. Total Applications and Patents involved.

Enter the total number of applications and patents identified for recordation. Be sure to include all applications and patents identified on the cover sheet and on additional pages.

Block 7. Total Fee Enclosed.

Enter the total fee enclosed or authorized to be charged. A fee is required for each application and patent against which the document is recorded.

Item 8. Payment Information.

Enter the deposit account number and authorized user name to authorize charges.

Item 9. Signature.

Enter the name of the person submitting the document. The submitter must sign and date the cover sheet. Enter the total number of pages including the cover sheet, attachments, and document.

This collection of information is required by 35 USC 261 and 262 and 15 USC 1057 and 1060. The information is used by the public to submit (and by the USPTO to process) patent and trademark assignment requests. After the USPTO records the information, the records for patent and trademarks, assignments, and other associated documents can be inspected by the public. To view documents recorded under secrecy orders or documents recorded due to the interest of the federal government, a written authorization must be submitted. This collection is estimated to take 30 minutes to complete, including gathering, preparing, and submitting the form to the USPTO. Any comments on the amount of time you require to complete this form and/or suggestions for reducing this burden, should be sent to the Manager of the Assignment Division, USPTO, P.O. Box 1450, Alexandria, VA 22313-1450. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450.

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Privacy Act Statement for Patent Assignment Recordation Form Cover Sheet

The Privacy Act of 1974 (P.L. 93-579) requires that you be given certain information in connection with the above request for information. This collection of information is authorized by 35 U.S.C. 1, 2, 261 and E.O. 9424. This information will primarily be used by the USPTO for the recordation of assignments related to patents and patent applications. Submission of this information is voluntary but is required in order for the USPTO to record the requested assignment. If you do not provide the information required on the cover sheet, the assignment will not be recorded, and all documents will be returned to you.

After the information is recorded, the records and associated documents can be inspected by the public and are not confidential, except for documents that are sealed under secrecy orders or related to unpublished patent applications. Assignment records relating to unpublished patent applications are maintained in confidence in accordance with 35 U.S.C. 122. Records open to the public are searched by users for the purpose of determining ownership for other property rights with respect to patents and trademarks.

Routine uses of the information you provide may also include disclosure to appropriate Federal, state, local, or foreign agencies in support of their enforcement duties and statutory or regulatory missions, including investigating potential violations of law or contract and awarding contracts or other benefits; to a court, magistrate, or administrative tribunal in the course of presenting evidence; to members of Congress responding to requests for assistance from their constituents; to the Office of Management and Budget in connection with the review of private relief legislation; to the Department of Justice in connection with a Freedom of Information Act request; to a contractor in the performance of their duties; to the Office of Personnel Management for personnel studies; and to the General Services Administration (GSA) as part of their records management responsibilities under the authority of 44 U.S.C. 2904 and 2906. Such disclosure to GSA shall not be used to make determinations about individuals.

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C. Trademark Assignments With Goodwill

§8.8 1. Introduction

Trademarks are notable in that they serve to carry the goodwill of their owner's business to the marketplace. Accordingly, trademark assignments cannot be made in isolation, but are required to be made together with a transfer of the goodwill that the trademark represents. See 15 USC §1060(a)(1). A "bare" trademark assignment (known as an assignment in gross), unaccompanied by the associated goodwill, is invalid. *E.&J. Gallo Winery v Gallo Cattle Co.* (9th Cir 1992) 967 F2d 1280, 1289. A typical form of assignment that correctly extends beyond the marks themselves to encompass goodwill is presented in §8.9.

Like patent assignments, trademark assignments must be recorded in the PTO to afford protection against subsequent purchasers for value without notice of the assignment. 15 USC §1060(a)(4). A cover sheet as prescribed by the PTO is required to be filed along with the assignment document. A copy of the cover sheet is reproduced in §8.10, and is available for downloading at http://www.uspto.gov/web/forms/pto1594.pdf.

There are special issues concerning an assignment of a pending trademark application. An intent-to-use application may not be assigned before the applicant files an amendment to allege use under 15 USC §1051(d), unless the transfer is to a successor to the applicant's business (as in a merger or other sale of the company to a third party) or to that portion of the business to which the mark pertains. 15 USC §1060; 37 CFR §3.16.

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.9 2. Form: Trademark and Goodwill Assignment

§8.9 2. Form: Trademark and Goodwill Assignment

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

8.9-1 Trademark and goodwill assignment

ASSIGNMENT OF TRADEMARK AND GOODWILL

This Assignment of Trademark and Goodwill (this "Assignment") is made this _ _[*date*]_ _, from _ _[*name of assignor*]_ _, a _ _[*e.g., California*]_ _ corporation with a principal place of business at _ _[*address*]_ _ ("Assignor"), to _ _[*name of assignee*]_ _, a _ _[*e.g., Delaware*]_ _ corporation with a principal place of business at _ _[*address*]_ _ ("Assignee"). This Assignment is effective as of _ _[*date*]_ _.

RECITALS

A. Assignor has registered, is the sole owner of, and is using the trademark described in the Schedule below (the "Trademark").

B. Assignor has agreed to assign the Trademark to Assignee, and Assignee wishes to acquire the Trademark.

ASSIGNMENT

In consideration of the payment of $_ _[*amount*]_ _, receipt of which is hereby acknowledged, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Assignor hereby assigns to Assignee all right, title, and interest in and to the Trademark, together with the goodwill of the business symbolized by the Trademark, the registration thereof, and all rights of action, powers, and benefits belonging or accrued to the Trademark, including the right to take action against any person for any infringement of the Trademark occurring before the effective date of this Assignment.

Schedule

Trademark	***Registration No.***	***Class***

IN WITNESS WHEREOF, this Assignment is executed on the day and year first above written.

Assignor:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

State of California)
County of _ _[*name of county*]_ _)
)
)

_____)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ *[Officer's seal]*

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.10 3. Form: Trademark Cover Sheet

§8.10 3. Form: Trademark Cover Sheet



Form **PTO-1594** (Rev. 01-09)
OMB Collection 0651-0027 (exp. 02/28/2009)

U.S. DEPARTMENT OF COMMERCE
United States Patent and Trademark Office

RECORDATION FORM COVER SHEET
TRADEMARKS ONLY

To the Director of the U. S. Patent and Trademark Office: Please record the attached documents or the new address(es) below.

1. Name of conveying party(ies):

☐ Individual(s) ☐ Association
☐ General Partnership ☐ Limited Partnership
☐ Corporation- State:_____
☐ Other_____

Citizenship (see guidelines)_____

Additional names of conveying parties attached? ☐ Yes ☐ No

2. Name and address of receiving party(ies)

Additional names, addresses, or citizenship attached? ☐ Yes ☐ No

Name:_____
Internal Address:_____
Street Address:_____
City:_____
State:_____
Country:_____ Zip:_____

☐ Association Citizenship _____
☐ General Partnership Citizenship _____
☐ Limited Partnership Citizenship _____
☐ Corporation Citizenship_____
☐ Other_____ Citizenship _____

If assignee is not domiciled in the United States, a domestic representative designation is attached: ☐ Yes ☐ No
(Designations must be a separate document from assignment)

3. Nature of conveyance)/Execution Date(s) :

Execution Date(s)_____

☐ Assignment ☐ Merger
☐ Security Agreement ☐ Change of Name
☐ Other_____

4. Application number(s) or registration number(s) and identification or description of the Trademark.

A. Trademark Application No.(s)

B. Trademark Registration No.(s)

Additional sheet(s) attached? ☐ Yes ☐ No

C. Identification or Description of Trademark(s) (and Filing Date if Application or Registration Number is unknown):

5. Name & address of party to whom correspondence concerning document should be mailed:

Name:_____
Internal Address:_____
Street Address:_____
City:_____
State:_____ Zip:_____
Phone Number:_____
Fax Number:_____
Email Address:_____

6. Total number of applications and registrations involved:

7. Total fee (37 CFR 2.6(b)(6) & 3.41) $_____

☐ Authorized to be charged to deposit account
☐ Enclosed

8. Payment Information:

Deposit Account Number _____
Authorized User Name _____

9. Signature:

_____ _____
Signature Date

_____
Name of Person Signing

Total number of pages including cover sheet, attachments, and document:

Documents to be recorded (including cover sheet) should be faxed to (571) 273-0140, or mailed to:
Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450

Print

Guidelines for Completing Trademarks Cover Sheets (PTO-1594)

Cover Sheet information must be submitted with each document to be recorded. If the document to be recorded concerns both patents and trademarks, separate patent and trademark cover sheets, including any attached pages for continuing information, must accompany the document. All pages of the cover sheet should be numbered consecutively for example, if both a patent and trademark cover sheet is used, and information is continued on one additional page for both patents and trademarks, the pages of the cover sheet would be numbered from 1 to 4.

Item 1. Name of Conveying Party(ies).
Enter the full name of the party(ies) conveying the interest. If there is more than one conveying party, enter a check mark in the "Yes" box to indicate that additional information is attached. The name of the second and any subsequent conveying party(ies) should be placed on an attached page clearly identified as a continuation of the information in Item 1. Enter a check mark in the "No" box, if no information is contained on an attached page.

Item 2. Name and Address of Receiving Party(ies).
Enter the name and full address of the first party receiving the interest. If there is more than one party receiving the interest, enter a check mark in the "Yes" box to indicate that additional information is attached. If the receiving party is an individual, check the "other" box, place the word "individual" in the following line, and enter the citizenship of the receiving individual. If the receiving party is a legal entity, designate the legal entity of the receiving party by checking the appropriate box. If the receiving party has more than one citizenship, then the citizenship of **each** partner should be specified on an additional sheet, and "See additional sheet" should be written on the line for citizenship. A corporation must set forth the state, if applicable, or country of incorporation. An association must set forth the state, if applicable, or country under which they are organized. If the receiving party is not domiciled in the United States, a designation of domestic representative is encouraged. Place a check mark in the appropriate box to indicate whether or not a designation of domestic representative is attached. Enter a check mark in the "No" box if no information is contained on an attached page.

Item 3. Nature of Conveyance/Execution Date(s).
Enter the execution date(s) of the document. It is preferable to use the name of the month, or an abbreviation of that name, to minimize confusion over dates. In addition, place a check mark in the appropriate box describing the nature of the conveying document. If the "Other" box is checked, specify the nature of the conveyance. The "Other" box should be checked if the conveying/receiving party is correcting a previously filed document.

Item 4. Application Number(s) or Registration Number(s).
Indicate the application number(s) including series code and serial number, and/or registration number(s) against which the document is to be recorded. The identification of the trademark should be provided for all properties to avoid recordation against the wrong property. A filing date should be provided only when the application or registration number is unknown. Enter a check mark in the appropriate box: "Yes" or "No" if additional numbers appear on attached pages. Be sure to identify numbers included on attached pages as the continuation of Item 4.

Item 5. Name and Address of Party to whom correspondence concerning document should be mailed.
Enter the name and full address of the party to whom correspondence is to be mailed.

Item 6. Total Applications and Trademarks Involved.
Enter the total number of applications and trademarks identified for recordation. Be sure to include all applications and registrations identified on the cover sheet and on additional pages.

Block 7. Total Fee Enclosed.
Enter the total fee enclosed or authorized to be charged. A fee is required for each application and registration against which the document is recorded.

Item 8. Payment Information.
Enter the deposit account number and authorized user name to authorize charges.

Item 9. Signature.
Enter the name of the person submitting the document. The submitter must sign and date the cover sheet. Enter the total number of pages including the cover sheet, attachments, and document.

This collection of information is required by 35 USC 261 and 262 and 15 USC 1057 and 1060. The information is used by the public to submit (and by the USPTO to process) patent and trademark assignment requests. After the USPTO records the information, the records for patent and trademarks, assignments, and other associated documents can be inspected by the public. To view documents recorded under secrecy orders or documents recorded due to the interest of the federal government, a written authorization must be submitted. This collection is estimated to take 30 minutes to complete, including gathering, preparing, and submitting the form to the USPTO. Any comments on the amount of time you require to complete this form and/or suggestions for reducing this burden, should be sent to the Manager of the Assignment Division, Crystal Gateway 4, Room 310, 1213 Jefferson Davis Highway, Arlington, VA 22202. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450.

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D. Copyright Assignments

§8.11 1. Introduction

Like patent and trademark assignments, assignments of copyrights are required to be in writing. 17 USC §204(a). A basic form of copyright assignment is presented in §8.12. If the copyright is registered with the U.S. Copyright Office, the assignment must be recorded there to afford protection against subsequent purchasers for value without notice of the assignment. 17 USC §205(a), (c). A cover sheet as prescribed by the U.S. Copyright Office is required to be filed along with the assignment. A copy of the cover sheet is reproduced in §8.14 and is available for downloading at http://www.copyright.gov/circs/circ12.pdf.

At times, assignments for software, audiovisual works, architectural works, artwork, and other works protected mainly by the copyright laws will include slightly different language than straight copyright assignments. For example, in some jurisdictions, most notably in Europe, "moral rights" associated with a copyright (or with the economic rights normally thought of as a copyright) cannot be assigned, but are waivable, and copyright assignments will often include such waivers. Further, the assignment may encompass rights in addition to copyright, such as trade secrets. A sample assignment form for software, which includes moral rights and trade secrets, is provided in §8.13.

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.12 2. Form: Basic Copyright Assignment

§8.12 2. Form: Basic Copyright Assignment

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

8.12-1 Assignment of copyright

ASSIGNMENT OF COPYRIGHT

This Assignment of Copyright (this "Assignment") is made as of _ _[*date*]_ _, from _ _[*name*]_ _ ("Assignor") to _ _[*name*]_ _ ("Assignee").

1. Assignor is the owner of the following copyrighted works (the "Works"):

[*Insert identifying information such as title of work and copyright registration, if any*]

2. For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Assignor hereby assigns and transfers to Assignee all of Assignor's interest in the Works and in the copyrights thereto, together with all rights to secure registrations, renewals, reissues, and extensions of the copyrights thereto.

3. Assignor hereby covenants, warrants, and represents to Assignee that:

(a) Assignor is the sole owner of and has the exclusive right to use the Works and the copyrights therein, free and clear of any liens, encumbrances, licenses, or claims of any nature, and has made no agreement with respect to the Works or the copyrights therein that is in conflict with this Agreement.

(b) Except as specified in Paragraph 1 of this Assignment, no other copyright has been effected, nor has any other registration relating to copyright protection been made with respect to the Works.

(c) If Assignor is an individual, Assignor agrees to authorize and direct his or her heirs and personal representatives to make and execute any instrument and perform any legal act that Assignee may deem necessary to secure the copyright, or any renewal or extension of the copyright to the Works.

4. This Assignment is governed by the laws of the State of California without regard to its conflict of law rules.

IN WITNESS WHEREOF, Assignor has executed this Assignment by its duly authorized representative.

Date: _ _ _ _ _ _

Assignor:
_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _
_ _[*Address*]_ _

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to**

me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

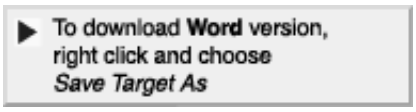
WITNESS my hand and official seal:

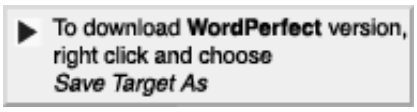
__[*Signature of officer*]__ *[Officer's seal]*

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.13 3. Form: Assignment for Software

§8.13 3. Form: Assignment for Software





8.13-1 Assignment for software

ASSIGNMENT

For good and valuable consideration, receipt of which is hereby acknowledged, _ _[*name*]_ _, a _ _[*e.g., California*]_ _ corporation with offices at _ _[*address*]_ _ ("Assignor"), has assigned and does hereby assign and transfer to _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation with offices at _ _[*address*]_ _ ("Assignee"), Assignor's entire right, title, and interest in and to any and all Proprietary Information in that certain software product known as _ _[*name of software product*]_ _, and any and all modules, portions, or other works contained therein or related thereto (the "Work").

For purposes herein, "Proprietary Information" includes without limitation inventions, discoveries, improvements, works of authorship, formulas, processes, compositions of matter, computer programs, code, databases, mask works, trade secrets, designs, notes, drawings, marketing plans, product plans, business strategies, financial information, forecasts, copyrights, patent rights, Moral Rights (as defined below), other intellectual property rights, and the right to bring suit thereunder.

For purposes of this Assignment, the term "Moral Rights" includes, without limitation, the right to be known as the author, the right to object to any alterations to a work, the right to prevent others from being named as the author of a work, the right to prevent others from falsely attributing to one the authorship of work that one has not in fact written, the right to prevent others from making deforming changes in a work, the right to withdraw a published work from distribution if it no longer represents the views of the author, and the right to prevent others from using a work or the author's name in such a way as to reflect on the author's professional standing. Assignor furthermore waives and agrees never to assert any Moral Rights that Assignor may have in the Work.

Assignor agrees that on request and without further consideration, but at the expense of Assignee, Assignor shall communicate to the Assignee or its representatives or nominees any facts known to the Assignor respecting said Proprietary Information, and shall testify in any legal proceeding, sign all lawful papers, execute all applications and confirmations, make all rightful oaths, and generally do everything possible to aid the Assignee, its successors, assigns, and nominees to obtain, maintain, perfect, and enforce rights in the Proprietary Information.

Date: _ _ _ _ _ _

Assignor:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

State of California)
County of _ _[*name of county*]_ _)
)
)
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to**

me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ *[Officer's seal]*

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.14 4. Form: U.S. Copyright Office Cover Sheet

§8.14 4. Form: U.S. Copyright Office Cover Sheet



Document Cover Sheet

UNITED STATES COPYRIGHT OFFICE

Copyright Office fees are subject to change.
For current fees check the Copyright Office website at *www.copyright.gov*, write to the Copyright Office, or call (202) 707-3000.

For Recordation of Documents

Volume _____ Document _____

Volume _____ Document _____

Date of recordation M _____ D _____ Y _____
(ASSIGNED BY THE COPYRIGHT OFFICE)

Funds received _____

DO NOT WRITE ABOVE THIS LINE · SEE INSTRUCTIONS ON REVERSE

To the Register of Copyrights: *Please record the accompanying original document or properly certified copy thereof.*

1 First party name given in the document _____
(IMPORTANT: *Please read instruction for this and other spaces.*)

2 First title given in the document _____

3 Total number of titles in the document _____

4 Amount of fee calculated _____

5 Fee enclosed

☐ Check ☐ Money order
☐ Fee authorized to be charged to Copyright Office deposit account

Deposit account number _____

Deposit account name _____

6 Completeness of document

☐ Document is complete by its own terms ☐ Document is not complete. Record "as is."

IMPORTANT NOTE: *A request to record a document "as is" under 37 CFR §201.4(c)(2) is an assertion that: (a) the attachment is completely unavailable for recordation; (b) the attachment is not essential to the identification of the subject matter of the document; and (c) it would be impossible or wholly impracticable to have the parties to the document sign or initial a deletion of the reference to the attachment.*

7 Certification of Photocopied Document

Complete this certification if a photocopy of the original signed document is substituted for a document bearing the actual original signature.
NOTE: *This space* may not *be used for documents that require an official certification.*

I declare under penalty of perjury that the accompanying document is a true and correct copy of the original document.

Signature _____ Date _____

Duly authorized agent of _____

8 Return to:

Name _____

Number/street _____ Apt/suite _____

City _____ State _____ Zip _____

Phone number _____ Fax number _____

Email _____

SEND TO: *Library of Congress, Copyright Office, Documents Recordation Section, 101 Independence Avenue SE, Washington, DC 20559-6000*
INCLUDE ALL THESE TOGETHER: (1) Two copies of this form; (2) payment from a deposit account or by check/money order payable to *Register of Copyrights*; and (3) your document.

FORM DCS REV: 09/2007 PRINT: 09/2007—••,000 Printed on recycled paper U.S. Government Printing Office: 2007-330-945/60,•••

Print

Document Cover Sheet · Basic Information

Read all of the instructions below before completing this form. Use of the Document Cover Sheet is optional but encouraged.

When to use this form Use the Document Cover Sheet when you are submitting a document for recordation in the U.S. Copyright Office.

Mailing requirements It is important to send the original cover sheet and one copy of the cover sheet for each document that is being submitted for recordation. The two copies of the Document Cover Sheet, the document, and the fee must be sent together in the same envelope or package. The Copyright Office cannot process them unless they are received together. Send to: *Library of Congress, Copyright Office, Documents Recordation Section, 101 Independence Avenue SE, Washington, DC 20559-6000*

Cover sheets should be typed or printed and should contain the information requested so that the Copyright Office can process the document and return it. Be sure to complete space 8 so that the recorded document can be returned. The Copyright Office will process the document based on the information in the document or an attachment that is part of the document. Information for indexing will not be taken from the Document Cover Sheet or attachments that were *not* part of the document when it was executed (signed). To be recorded, the document must satisfy the recordation requirements of the copyright law and Copyright Office regulations.

The person submitting a document with a cover sheet is solely responsible for verifying the correctness of the cover sheet and the sufficiency of the document. Recording a document submitted with or without a cover sheet does not constitute a determination by the Copyright Office of the document's validity or effect. Only a court may make such a determination.

When a Document Cover Sheet is submitted, it will be imaged with the document as part of the public record.

PRIVACY ACT ADVISORY STATEMENT (*Required by the Privacy Act of 1974 (P.L. 93-579)*): The authority for requesting this information is title 17 *USC*, sec. 205. Furnishing the requested information is voluntary. But if the information is not provided, it may be necessary to delay recordation.

The principal uses of the requested information are the establishment and maintenance of a public record and the evaluation for compliance with the recordation requirements of section 205 of the copyright code. Other routine uses include public inspection and copying, preparation of public indexes, preparation of public catalogs of copyright recordations, and preparation of search reports upon request.

NOTE: No other advisory statement will be given in connection with this application. Please keep this statement and refer to it if we communicate with you regarding this cover sheet.

Space-by-Space Instructions

Space 1: First party given in the document This information is only used to connect the Document Cover Sheet and the document if they become separated. No information is entered in the catalog record from this space.

Space 2: First title given in the document This information is only used to connect the Document Cover Sheet and the document if they become separated. No information is entered in the catalog record from this space.

Space 3: Total number of titles in the document The total number of titles (including a.k.a. and other variant titles of a work) determines the recordation fee. In the case of multiple title documents, titles that are repeated in documents are counted as a single title, except where the document lists different issues, volumes, episode numbers, etc. following each title. Each such entry is regarded as a separate title and will be indexed separately and counted separately when computing the fee for recording the document. The Copyright Office verifies title counts.

Space 4: Amount of fee calculated There is a basic fee for recording a document containing one title. There is an additional charge for each group of up to 10 additional titles. "Alternative" titles, "formerly-known-as" titles, and "also-known-as" titles are considered to be extra titles. Titles are counted by groups. If there are fewer than 10 titles in a group, the fee for a group still applies. Copyright Office fees are subject to change. For current fees, check the Copyright Office website at *www.copyright.gov*, write the Copyright Office, or call (202) 707-3000. Please remember that the fee is based on the number of titles in a document, not the number of works.

Space 5: Fee enclosed Check the appropriate box. If a Copyright Office deposit account is to be charged, give the Copyright Office deposit account number and name. The Office only accepts domestic money orders and checks payable through a U.S. bank with American Bankers Association routing numbers. International and postal money orders are not accepted.

Space 6: Completeness of document Check the appropriate box. Please read the "Important note"if checking "Record 'as is.'"All documents recorded under §205 of the Copyright Act must be complete by their own terms to be recorded. Notices of termination recorded under §203, §304(c), and §304(d) must be complete and exact duplicates of the notices as served. Please refer to Copyright Office regulations in Chapter 37 *CFR* §201.4 and §201.10 and Circular 12, *Recordation of Transfers and Other Documents*, for more information.

Space 7: Certification of photocopied documents Complete this section only if submitting a photocopied document in lieu of a document bearing the actual original signature. If a photocopy of the original signed document is submitted, it must be accompanied by a sworn certification. A sworn certification signed by at least one of the parties to the document or that party's authorized representative (who is identified as such at space 7) will satisfy that requirement. The date entered in the date field should be the date you sign the Document Cover Sheet. Copies of documents on file in a federal, state, or local government office must be accompanied by an original official certification.

Space 8: Return to Give the name and address of the person to whom the recorded document should be returned. The Copyright Office does not maintain paper files of recorded documents. The documents are imaged and returned to the person or firm designated in this space. Please include telephone number, fax number, and email address in case we need to contact you.

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E. Employee and Independent Contractor Invention Assignments and Confidentiality Agreements

§8.15 1. Introduction

The due diligence investigation typically performed in advance of an M&A transaction may uncover cases in which employees or independent contractors either never signed employee invention assignments or signed forms of agreement that might not be fully effective. Particularly because some employee transition normally takes place in connection with an M&A transaction, it is common for new employee invention assignment agreements to be negotiated and executed in connection with the closing.

There are numerous considerations in drafting employment agreements, most of which are beyond the scope of this book. For general information concerning preparation and forms of employment agreements, see Advising California Employers and Employees, chap 2 (Cal CEB 2005). This discussion focuses on the aspects of employment contracts that relate to the ownership of intellectual property created by an employee during his or her employment. See also §§6.37-6.40.

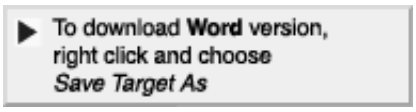
The "work made for hire" doctrine under federal copyright law holds that works prepared by employees within the scope of their employment are automatically owned by the employer. See 17 USC §§101, 201(b). The employee is not even considered an author of the work; the employing corporation is deemed to be the original author and owner of the work unless the parties agree otherwise in writing. The status of employee inventions as employer-owned is addressed similarly in California statutes. See Lab C §§2860, 2870(a).

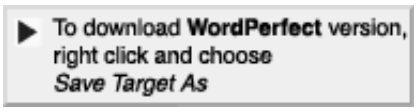
It is not always clear, however, whether a particular work is within the scope of the employee's employment. Further, the "work made for hire" rule is work-specific. Employers may have significant difficulty establishing either equitable or legal title to inventions made by their employees in the absence of an agreement expressly assigning such inventions to the company. Accordingly, most companies include invention assignments in employment agreements. A sample form of such an agreement is provided in §8.16. For a case in which such an agreement was enforced against former employees, see *Iconix, Inc. v Tokuda* (ND Cal 2006) 457 F Supp 2d 969.

Confidentiality provisions may be included in an employee or independent contractor agreement (as in the examples in §§8.16-8.17) or may be set forth in a separate confidentiality agreement that describes in greater detail what is to be protected and how it is to be protected. Employees for whom an invention assignment would not be appropriate, such as a vice president of sales as distinct from an engineer, may execute confidentiality agreements that do not contain invention assignments.

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§8.16 2. Form: Employee Confidentiality and Proprietary Rights Agreement





8.16-1 Employee confidentiality and proprietary rights agreement

EMPLOYEE CONFIDENTIALITY
AND PROPRIETARY RIGHTS AGREEMENT

This agreement ("Agreement") is entered into and effective as of _ _[*date*]_ _, between _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation having a principal place of business at _ _[*address*]_ _, and its subsidiaries, affiliates, or corporate or other successors, if any (collectively, "Company"), and _ _[*name*]_ _, an individual residing at _ _[*address*]_ _ ("Employee").

Employee understands that Company is engaged in a continuous program of research, development, production, and marketing in connection with its business and that it is critical for Company to preserve and protect its "Confidential Information" (as defined in Section 1.1 below) and its rights in "Developments" (as defined in Section 2.1 below) and all related intellectual property rights. Accordingly, in consideration of and as a condition of Employee's employment with the Company, Employee agrees as follows:

1. *Confidential Information*

1.1. *Definition.* "Confidential Information" means any tangible or intangible information or material that is confidential or proprietary to Company, and that Employee may obtain knowledge of through or as a result of the relationship with Company. Such information shall be deemed Confidential Information whether or not owned or developed by Company.

Confidential Information includes, but is not limited to, information relating to Company products and their features and modes of operation, Developments (as defined in Section 2.1 below), know-how, inventions (whether or not patentable), programs, algorithms, schematics, testing procedures, software design and architecture, computer code, internal documentation, design and function specifications, problem, or other reports, analysis and performance information, software documents and other technical, business, product, marketing, or financial information, plans, or other subject matter pertaining to Company or any of its customers, consultants, or licensees. Confidential Information also includes information obtained from transactional flow-through data, as well as the Company's proprietary analysis or aggregation of publicly available or privately provided information and such flow-through data.

Confidential Information does not include information, technical data, or know-how that is now or becomes public other than as a result of improper means.

1.2. *Company Information.* Employee agrees, at all times during and after employment with Company, to hold in strictest confidence and to not use, except for the sole benefit of Company, all Confidential Information. Employee also agrees not to disclose any Confidential Information to any person, firm, or entity outside of Company without the prior express written authorization of a duly authorized officer of Company.

1.3. *Former Employer Information.* Employee agrees, at all times during employment with Company, not to use or disclose any confidential or proprietary information of former or concurrent employers or companies, if any, and not to bring onto Company premises any unpublished document or any confidential or proprietary information belonging to any former employer or other third party, unless consented to in writing by the applicable employer or third party.

1.4. *Third Party Information.* Employee recognizes that Company has received, and will continue to receive, confidential or proprietary information from third parties subject to a duty on Company's part to maintain the confidentiality of such information and to use it only for certain limited purposes. Such

information may include, but is not limited to, financial, marketing, or business results and plans of Company's customers and consultants. Employee agrees at all times during and after employment with Company to hold any such third party's confidential or proprietary information in the strictest confidence and not to disclose it to any person, firm, or corporation, except as is necessary in carrying out the work for Company consistent with Company's agreement with such third party.

2. *Retaining and Assigning Developments*

2.1. *Definition.* "Developments" shall include without limitation any invention, discovery, know-how, research finding, improvement, source code, object code, original work of authorship (including but not limited to computer software, data, or any other literary, audio-visual, or artistic work), or other development that Employee, either solely or jointly with others, conceives, reduces to practice, modifies, or enhances during the period of employment, within or without normal working hours, unless otherwise exempted by the terms of this Article 2.

2.2. *Preexisting Works Retained by Employee.* Attached hereto as Exhibit A is a list of all preexisting works that were conceived or reduced to practice by Employee before the effective date of this Agreement (collectively, the "Preexisting Works"). The Preexisting Works shall not be subject to Section 2.3 below. If nothing is listed on Exhibit A, Employee represents that there are no Preexisting Works as of the effective date of this Agreement.

2.3. *Work for Hire; Developments Assigned to Company.* Employee acknowledges and agrees that any copyrightable works prepared by Employee within the scope of his or her employment are "works for hire" under the Copyright Act and any similar provision of state law, and that Company will be considered the author and owner of such copyrightable works. Employee agrees to promptly make full written disclosure to Company of all Developments, and shall hold in trust, for the sole right and benefit of Company, any such Developments. Employee agrees that all Developments (including all patent rights, trade secrets, copyrights, trademarks, and other proprietary rights therein, both domestic and foreign) shall be the exclusive and absolute property of Company, and Employee hereby grants, transfers, and assigns to Company Employee's entire right, title, and interest therein. Employee also agrees at all times during and after employment with Company, at Company's expense, to take any actions necessary to perfect Company's title therein. Employee hereby irrevocably designates and appoints Company (including its duly authorized officers and agents) as Employee's agent and attorney-in-fact to act in Employee's behalf, and to perform all lawfully permitted acts, in furtherance of Employee's obligation under this Section 2.3.

2.4. *Assignment of Other Rights.* In addition to the foregoing assignment to the Company, Employee agrees to assign, and does hereby irrevocably transfer and assign, to the Company: (i) all worldwide patents, patent applications, copyrights, mask works, trade secrets, and other intellectual property rights, including, but not limited to, rights in databases and rights in Developments, along with any registrations of or applications to register such rights; and (ii) any and all "Moral Rights" (as defined below) that Employee may have. Employee also hereby forever waives and agrees never to assert any and all Moral Rights that Employee may have in or with respect to any Developments, even after termination of Employee's work on behalf of the Company. "Moral Rights" mean any rights to claim authorship of or credit on a Development, to object to or prevent the modification or destruction of any Development _ _[*or preexisting works licensed to Company pursuant to Exhibit A*]_ _, or to withdraw from circulation or control the publication or distribution of any Development _ _[*or preexisting works licensed to Company pursuant to Exhibit A*]_ _, and any similar right, existing under judicial or statutory law of any country or subdivision thereof in the world, or under any treaty, regardless of whether or not such right is denominated or generally referred to as a "moral right."

2.5. *Maintenance of Records.* Employee agrees to keep and maintain adequate and current written records of all inventions and original works of authorship made by Employee (solely or jointly with others) during the term of employment with Company. The records shall be kept in the form of notes, sketches, drawings, and any other format that may be specified by Company. The records shall be available and remain the sole property of Company at all times.

2.6. *Other Assignment Obligations.* Employee hereby acknowledges that Employee has no obligation to assign Developments conceived or developed by Employee in connection with employment with Company to any person or entity other than Company, and shall not undertake any such obligation.

2.7. *Labor Code §2870 Notice.* Employee has been notified and understands that the assignment

obligation of Section 2.3 to Company does not apply to any Invention that qualifies fully under the provisions of Section 2870 of the California Labor Code, which states as follows:

> **(a) ANY PROVISION IN AN EMPLOYMENT AGREEMENT WHICH PROVIDES THAT AN EMPLOYEE SHALL ASSIGN, OR OFFER TO ASSIGN, ANY OF HIS OR HER RIGHTS IN AN INVENTION TO HIS OR HER EMPLOYER SHALL NOT APPLY TO AN INVENTION THAT THE EMPLOYEE DEVELOPED ENTIRELY ON HIS OR HER OWN TIME WITHOUT USING THE EMPLOYER'S EQUIPMENT, SUPPLIES, FACILITIES, OR TRADE SECRET INFORMATION EXCEPT FOR THOSE INVENTIONS THAT EITHER: (1) RELATE AT THE TIME OF CONCEPTION OR REDUCTION TO PRACTICE OF THE INVENTION TO THE EMPLOYER'S BUSINESS, OR ACTUALLY OR DEMONSTRABLY ANTICIPATED RESEARCH OR DEVELOPMENT OF THE EMPLOYER, OR (2) RESULT FROM ANY WORK PERFORMED BY THE EMPLOYEE FOR THE EMPLOYER.**
>
> **(b) TO THE EXTENT A PROVISION IN AN EMPLOYMENT AGREEMENT PURPORTS TO REQUIRE AN EMPLOYEE TO ASSIGN AN INVENTION OTHERWISE EXCLUDED FROM BEING REQUIRED TO BE ASSIGNED UNDER CALIFORNIA LABOR CODE SECTION 2870(a), THE PROVISION IS AGAINST THE PUBLIC POLICY OF THIS STATE AND IS UNENFORCEABLE.**

Employee shall promptly advise Company of any Developments that are believed to meet the criteria set forth above and shall, at that time, provide written evidence to Company to substantiate that belief.

3. *Conflicting Employment.* Employee agrees, during the term of employment with Company, not to engage in any other employment, occupation, consulting, or other business activity that: (a) is directly related to the business in which Company is involved as of the date of this Agreement or becomes involved during the term of Employee's employment with Company; (b) competes directly or indirectly with the business in which Company is involved as of the date of this Agreement or becomes involved during the term of Employee's employment with Company; or (c) conflicts with any of Employee's obligations to Company.

4. *Returning Documents and Materials.* Employee agrees, at the time employment with Company ends, or at any other time on Company's request, to promptly deliver to Company, without keeping any copies, all Developments, Confidential Information, devices, equipment, records, data, notes, reports, proposals, lists, correspondence, specifications, drawings, data, other documents or property, or reproductions of any aforementioned items received or prepared by Employee in connection with employment with Company, whether stored electronically or otherwise.

5. *Business Interference.* Employee agrees not to interfere with Company's business in any manner during and after the period of employment with Company. Without limiting the generality of the foregoing, during the period of employment with Company, and for an additional _ _[*e.g., 1*]_ _-year period thereafter, Employee shall not induce any of the contractors, consultants, or employees of Company to sever their relationship with Company.

6. *"At Will" Employment.* This Agreement does not constitute a contract of employment or obligate the Company to employ Employee for any stated period of time. Either Company or Employee may terminate the employment relationship at any time, with or without good cause and with or without notice. Employee further understands that any obligations under this Agreement shall survive any termination of employment and are binding on Employee's heirs, assigns, and legal representatives.

7. *Export of Technical Data.* Employee agrees not to export, directly or indirectly, any technical data or any product to any country for which the U.S. Government, or any agency of the U.S. Government, at the time of export requires an export license or other government approval without first obtaining such license or approval. Employee understands that disclosing technical data to a foreign national constitutes an "export" even if the disclosure takes place within the United States.

8. *Miscellaneous Provisions*

8.1. *Governing Law.* This Agreement shall be governed by the laws of the State of California, without regard to its choice of law provisions.

8.2. *Entire Agreement.* This Agreement sets forth the entire agreement and understanding between Company and Employee and replaces any previous oral or written understandings or agreements between the parties with respect to Confidential information or proprietary information and rights. This Agreement may not be modified or amended except by a written agreement dated subsequent to the date of this Agreement and signed by both parties. No waiver of any provision of this Agreement shall constitute a waiver of any other

provision(s) or of the same provision on a different occasion.

8.3. *Severability.* If any provision of this Agreement is held by a court of competent jurisdiction to be illegal, invalid, or unenforceable, that provision shall be limited or eliminated to the minimum extent necessary so that the remaining provisions remain in full force and effect.

8.4. *Successors and Assigns.* This Agreement shall be binding on Employee's heirs, executors, administrators, and other legal representatives and shall be binding for the benefit of Company, its successors, and assigns.

8.5. *Relief.* Employee agrees and acknowledges that the obligations and promises hereunder are necessary and reasonable to protect the business of Company, and that failure to fulfill any such obligation or promise will cause irreparable harm and damage for which Company will have no adequate remedy at law. Accordingly, Employee agrees and acknowledges that if Employee fails to fulfill any obligation or promise hereunder, Company shall be entitled to injunctive relief or decree for specific performance, or both, as well as any other relief as may be deemed proper by a court of competent jurisdiction.

Date: _ _ _ _ _ _

Employee:
__[*Signature*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _

Company:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

EXHIBIT A
PREEXISTING WORKS OWNED BY EMPLOYEE

For the purposes of this Agreement, Developments assigned to Company pursuant to Section 2.3 shall not include the Preexisting Works owned by Employee prior to performance under this Agreement as described below. Employee grants Company and Company's affiliates and associates, a royalty-free, irrevocable, worldwide, nonexclusive license to make, have made, use, sell, disclose, reproduce, modify, make derivative works based on, distribute, perform, and display such Preexisting Works solely as necessary to make, have made, use, sell, disclose, reproduce, modify, make derivative works based on, distribute, perform, and display the Developments assigned to Company pursuant to Section 2.3. Subject to this license grant, Employee shall retain all right, title, and interest in the Preexisting Work.

Employee represents, warrants, and agrees that Company's activities under the above license will not infringe any copyright, patent, trade secret, or other proprietary right held by any third party, and Employee agrees to indemnify and hold harmless Company with regard to any such infringement.

The Preexisting Works are set forth below:

_____

_____

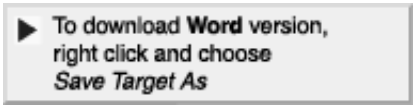
_____

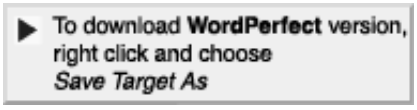
_____

_____

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§8.17 3. Form: Independent Contractor Confirmatory Assignment and License Agreement





8.17-1 Independent contractor confirmatory assignment and license agreement

INDEPENDENT CONTRACTOR
CONFIRMATORY ASSIGNMENT AND LICENSE AGREEMENT

This Confirmatory Assignment and License Agreement ("Agreement"), effective as of _ _[*date*]_ _ ("Effective Date"), is entered into between _ _[*name of company*]_ _, a _ _[*e.g., Delaware*]_ _ corporation with a principal place of business at _ _[*address*]_ _ ("Company"), and _ _[*name*]_ _, an individual residing at _ _[*address*]_ _ ("Contractor").

RECITALS

A. Contractor has provided and continues to provide certain professional services to Company, including, without limitation, software development and software engineering.

B. The parties confirm that it was intended that Contractor assign to Company any and all work product performed by or developed by Contractor for Company ("Contractor Work Product") and the Contractor IPR (as defined in Section 1.2 below), but that Contractor may not have formally or completely assigned the Contractor Work Product or the Contractor IPR to Company.

C. In connection with the Contractor Work Product, Contractor may have provided Company with certain background technology, which was not part of the Contractor Work Product or the Contractor IPR ("Background Technology"). The parties confirm that Contractor intended to grant Company a perpetual, irrevocable license to the Background Technology under all of Contractor's Intellectual Property Rights (as defined in Section 1.1 below), but Contractor may not have formally or completely licensed the Background Technology to Company.

D. The assignment and license contained in this Agreement implements the parties' original intent by (i) assigning, transferring, and confirming the assignment and transfer to Company of any and all right, title, and interest in and to the Contractor Work Product and the Contractor IPR; and (ii) licensing and confirming the license to Company of the Background Technology, and documents the parties' prior understanding and agreement with respect thereto.

AGREEMENT

NOW THEREFORE, for good and valuable consideration, the receipt and sufficiency of which the parties hereby acknowledge, the parties agree as follows:

1. DEFINITIONS

1.1. "Intellectual Property Rights" means all intellectual property or other similar rights arising out of: (i) any patent or any application therefor and any and all reissues, divisions, continuations, renewals, reexaminations, extensions, and continuations-in-part thereof; (ii) inventions (whether patentable or not in any country), invention disclosures, industrial designs, improvements, trade secrets, proprietary information, know-how, technology, and technical data; (iii) copyrights, copyright registrations, and applications therefor in any country, and all other rights corresponding thereto throughout the world; (iv) registered or common law trademarks, service marks, trade dress, trade names, logos, intent-to-use registrations or notices, and applications to register or use any of the foregoing anywhere in the world; (v) other proprietary rights in technology, including databases, software, all source and object code, algorithms, architecture, structure, display screens, layouts, inventions, development tools, and all documentation and media constituting,

describing, or relating to the above, including, without limitation, manuals, memorandums, records, or business information, anywhere in the world; and (vi) any applications, registrations, provisional applications, or other filings for, or to obtain, protect, perfect, or secure any of the foregoing, anywhere in the world.

1.2. "Contractor IPR" means all Intellectual Property Rights arising from, relating to, or embodied in the Contractor Work Product.

2. ASSIGNMENT AND LICENSE

2.1. *Assignment.* Contractor hereby irrevocably assigns, conveys and transfers to Company any and all of Contractor's right, title, and interest (i) to the Contractor Work Product, (ii) to the Contractor IPR, and (iii) in all rights to enforce such rights, including the right to sue and recover any sums now or hereafter due or payable with respect to any of the Contractor IPR.

2.2. *Background Technology License.* Contractor hereby grants to Company a nonexclusive, royalty-free, irrevocable, perpetual, worldwide, transferable license under all of Contractor's Intellectual Property Rights to make, have made, use, offer to sell, sell, import, copy, modify, create derivative works based on, distribute, sublicense (through multiple tiers), display, perform, and transmit the Background Technology, to the extent necessary to enable Company to exercise all of the rights assigned to Company under this Agreement. This Section 2.2 shall survive any termination of this Agreement.

2.3. *Perfection of Assignment and License.* Contractor shall sign such documents and take such steps as Company may reasonably require, at the cost and expense of Company, to enable Company to acquire, perfect, and enforce its Intellectual Property Rights and other legal protections for the Contractor Work Product, Contractor IPR, and other rights and licenses assigned or granted hereunder. Contractor hereby appoints each of the current and future officers of Company as Contractor's attorney-in-fact during such time as each is an officer to Company to execute documents on behalf of Contractor for this purpose.

2.4. *Waiver of Moral Rights.* Contractor hereby waives any and all moral rights, including, without limitation, rights of attribution, integrity, and disclosure, arising from the Contractor Work Product, the Contractor IPR, and the Background Technology, together with all claims for damages and other remedies asserted on the basis of moral rights, and assigns, transfers, and conveys to Company any waivers granted to Contractor of any such moral rights.

3. REPRESENTATIONS AND WARRANTIES

Contractor represents and warrants to Company that: (i) Contractor has not assigned or licensed any right, title, or interest in or to any of the Contractor Work Product or Contractor IPR to any third party; and (ii) Contractor has all rights necessary to grant the licenses to the Background Technology set forth in this Agreement.

4. CONFIDENTIALITY

Contractor acknowledges that the Contractor Work Product and Contractor IPR constitute trade secrets and confidential and proprietary information of Company. Contractor agrees to hold all Contractor Work Product and Contractor IPR in strict confidence, and, except as expressly authorized by Company, agrees not to disclose it to others or use it in any way, commercially or otherwise. Contractor further agrees to take all action reasonably necessary to protect the confidentiality of the Contractor Work Product and Contractor IPR including, without limitation, implementing and enforcing operating procedures to minimize the possibility of unauthorized use or copying of the Contractor Work Product and Contractor IPR.

5. GENERAL PROVISIONS

5.1. *Non-Waiver.* The failure of any party at any time to require performance by the other party of any provision hereof shall not affect in any way the full right to require such performance at any time thereafter, nor shall the waiver by any party of a breach of any provision hereof be taken or held to be a waiver of the provision itself.

5.2. *Severability.* If any term of this Agreement is held invalid or unenforceable for any reason, the remainder of the provisions shall continue in full force and effect, and the parties shall substitute a valid

provision with the same intent and economic effect.

5.3. *Applicable Law.* This Agreement shall be governed by and construed in accordance with the laws of California without regard to its conflict of law principles.

5.4. *Entire Agreement.* On execution, this Agreement shall constitute the entire agreement among the parties with respect to the subject matter hereof and merges all prior and contemporaneous communications. This Agreement shall not be modified except by a written agreement dated subsequent to the date of this Agreement and signed on behalf of the parties by their respective duly authorized representatives.

5.5. *Assignment.* Contractor may not assign this Agreement without the prior express written consent of Company. Company may assign this Agreement or any rights granted hereunder. Subject to the above restrictions on assignment, this Agreement shall inure to the benefit of and bind the successors and assigns of the parties.

5.6. *Counterparts.* This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which collectively shall constitute one and the same instrument.

5.7. *Headings and References.* The headings and captions used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement on _ _[*date*]_ _, to be effective for all purposes as of the Effective Date.

Date: _ _ _ _ _ _

Company:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

Contractor:
__[*Signature*]__
_ _[*Typed name*]_ _

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F. Forms Used for Transfer of Internet Domains

§8.18 1. Introduction

An intellectual property issue closely related to trademark analysis concerns Internet domains. When one company acquires another, the target's domain names must be transferred along with other intellectual property rights.

Domain name issues may also arise in due diligence. The same trademark can be registered by two different companies for different types of products. For example, United Airlines and United Van Lines share similar names for purposes of trademark registration, but only one of those companies can use the tradename "United" as an Internet domain name, and United Airlines has done so. See http://www.united.com. Further, it is common for companies to make inbound or outbound transfers of Internet domain names, and the transfer documents sometimes carry interesting conditions, such as a requirement to reference the transferring company's domain on the new owner's website.

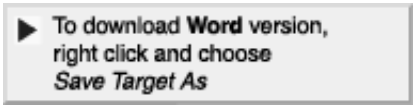
An example of a domain name assignment is presented in §8.19. A sample form of domain name transfer agreement is presented in §8.20. The form of agreement in §8.20 is more appropriate for use when a domain name is transferred outside the context of a larger transaction such as a merger or acquisition.

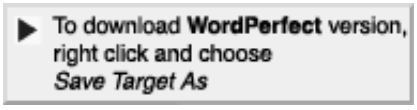
For additional discussion of domain names, including registration and transfer procedures and infringement claims, see Internet Law and Practice in California, chap 3 (Cal CEB 2004).

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.19 2. Form: Domain Name Assignment

§8.19 2. Form: Domain Name Assignment





8.19-1 Domain name assignment

DOMAIN NAME ASSIGNMENT

This Domain Name Assignment is entered into by _ _[*name*]_ _, a _ _[*e.g., California*]_ _ corporation, ("Assignor"), for the benefit of _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation ("Assignee").

RECITALS

A. Assignor and Assignee are parties to that certain Asset Purchase Agreement and related agreements, effective as of _ _[*date*]_ _ (collectively, the "Agreements"), pursuant to which Assignor agreed to sell, convey, transfer, assign, and deliver to Assignee all of Assignor's right, title, and interest in and to certain intellectual property, including all patent, copyright, trademark, and other intellectual property rights therein together with the business associated therewith; and

B. Assignor is the registrant of the registered domain names (the "Domain Names") as shown on the attached Schedule A.

ASSIGNMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Assignor does hereby assign and transfer unto Assignee the entire right, title, and interest of Assignor in and to the Domain Names, together with the goodwill of the business symbolized by the Domain Names, any and all common law rights to the Domain Names throughout the world, and any and all claims and demands it may have either at law or in equity arising out of any past infringements and uses of the Domain Names.

Assignor hereby expressly agrees that it shall provide such assistance and do all things as may be reasonably required to execute the transfer of the Domain Names to Assignee pursuant to the procedures of a domain name registrar (such as _ _[*name of registrar*]_ _) selected by Assignee.

Assignor represents that Assignor has the rights, titles, and interests to convey as set forth herein, and covenants with Assignee that the Assignor has made or will make hereafter no assignment, grant, mortgage, license, or other agreement affecting the rights, titles, and interests herein conveyed.

In witness whereof, this Domain Name Assignment has been executed on _ _[*date*]_ _.

Assignor:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

State of California)
County of _ _[*name of county*]_ _)
)
)
_____)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ *[Officer's seal]*

SCHEDULE A TO DOMAIN NAME ASSIGNMENT

Domain Names:

_ _[*Description of domain names*]_ _

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.20 3. Form: Domain Name Transfer Agreement

§8.20 3. Form: Domain Name Transfer Agreement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

8.20-1 Domain name transfer agreement

DOMAIN NAME TRANSFER AGREEMENT

This Domain Name Transfer Agreement ("Agreement") is entered into as of _ _[*date*]_ _ (the "Effective Date"), between _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation with a principal place of business at _ _[*address*]_ _ ("Buyer"), and _ _[*name*]_ _, an individual residing at _ _[*address*]_ _ ("Seller").

RECITALS

A. Seller has registered with _ _[*name of registrar*]_ _ (the "Registrar"), the domain name "_ _[*name*]_ _" (the "Domain Name").

B. Buyer and Seller are agreeable to a transfer of the Domain Name.

THEREFORE, in consideration of the mutual representations, promises, terms, and conditions contained herein, the parties agree as follows:

AGREEMENT

1. *Assignment of Rights.* Seller hereby sells, transfers, and assigns to Buyer (i) all right, title, and interest, worldwide, in and to the Domain Name, (ii) any registered or unregistered trademarks, service marks, copyrights, right of registration or re-registration, or other intellectual property or proprietary rights based on or related to the Domain Name (the "Intellectual Property Rights"), and (iii) all the goodwill associated with the Domain Name, if any. Seller acknowledges that Buyer shall have the exclusive right to own, use, and hold the Domain Name and to register the Domain Name as a trademark or service mark and to perfect whatever other Intellectual Property Rights Buyer deems prudent. Seller agrees that Seller shall not take or authorize any activity inconsistent with Buyer's ownership of and exclusive rights in the Domain Name.

2. *No Assumption of Past Liabilities.* Buyer does not assume, and Seller shall remain fully responsible for and shall indemnify and hold harmless Buyer against, any liabilities or obligations of any kind arising from or relating to Seller's use of the Domain Name prior to transfer to Buyer.

3. *Full Assumption of Future Liabilities.* Seller does not assume, and Buyer shall be fully responsible for and shall indemnify and hold harmless Seller against, any liabilities or obligations of any kind arising from or relating to Buyer's use of the Domain Name subsequent to transfer to Buyer.

4. *Procedures.* Seller agrees to immediately take the steps required by the Registrar's current procedures to transfer the Domain Name to Buyer. At and after the date hereof, Seller shall, without further consideration, provide or execute such other information or documents as may be necessary or appropriate to accomplish the transfer of the Domain Name on Buyer's reasonable request.

5. *Payment Obligations.* Subject to the effective transfer of the Domain Name as described in Section 1, Buyer agrees to pay Seller $_ _[*amount*]_ _ on receipt of electronic confirmation from Registrar that the Domain Name has been fully transferred on the books and records of Registrar to Buyer.

6. *Representations and Warranties.* Seller represents and warrants that:

6.1. *Title.* Seller is the sole owner of all right, title, and interest in the Domain Name. Immediately prior to the transfer of the Domain Name to Buyer, the Domain Name is properly registered to Seller with the

Registrar. The Domain Name is being transferred to Buyer free of any liens, encumbrances, restrictions, licenses, or security interests. Seller has not encumbered the Domain Name in any manner or transferred any right, title, or interest in and to the Domain Name to any third party.

6.2. *Authority.* Seller has the full right, power, and authority to enter into and perform this Agreement and to make the Domain Name transfer contained herein.

6.3. *No Conflict.* Seller has not entered into any other agreement that contains provisions that conflict with the rights granted in this Agreement.

6.4. *No Infringement.* To Seller's knowledge, the Domain Name is not the subject of any dispute or conflict and the use of the Domain Name, as of the date hereof, does not (and the use of the Domain Name by the Buyer will not) infringe on the Intellectual Property Rights of any third party. The Domain Name has not been, and is not currently, the subject of any litigation, claims, arbitration, or other legal proceeding nor has the Seller received any notice of any such pending actions. To Seller's knowledge, no protest relating to the Domain Name has been made with the Registrar or is currently threatened.

7. Cessation of Use. Seller covenants not to use or display the Domain Name or the Intellectual Property Rights anywhere in the world except with the prior written authorization of Buyer, and further covenants not to contest or challenge the validity of the Domain Name, or any applicable registrations thereof as used or made by Buyer.

8. *Limitation of Liability*

8.1. *General Limitation.* IN NO EVENT SHALL EITHER PARTY BE LIABLE FOR ANY INCIDENTAL, CONSEQUENTIAL, SPECIAL, OR ANY OTHER INDIRECT DAMAGES OF ANY KIND IN CONNECTION WITH THIS AGREEMENT, EVEN IF THE PARTY HAS BEEN INFORMED IN ADVANCE OF THE POSSIBILITY OF SUCH DAMAGES.

8.2. *Specific Limitation.* THE AGGREGATE LIABILITY OF EACH PARTY UNDER THIS AGREEMENT SHALL NOT EXCEED THE VALUE OF THE CONSIDERATION TRANSFERRED FROM BUYER TO SELLER UNDER SECTION 5 AS OF THE EFFECTIVE DATE.

9. *General Provisions*

9.1. *Successors and Assigns; Assignment.* Except as otherwise provided in this Agreement, this Agreement shall extend to, inure to the benefit of, and be binding on the parties hereto and their respective directors, officers, partners, proprietors, attorneys, agents, servants, employees, representatives, administrators, executors, affiliates, subsidiaries, shareholders, predecessors, successors, heirs, and assigns.

9.2. *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of California, without giving effect to its conflict of laws principles.

9.3. Severability. If any provision of this Agreement is determined by any court or arbitrator of competent jurisdiction to be invalid, illegal, or unenforceable in any respect, such provision shall be enforced to the maximum extent possible given the intent of the parties. If such clause or provision cannot be so enforced, such provision shall be stricken from this Agreement and the remainder of this Agreement shall be enforced as if such invalid, illegal, or unenforceable clause or provision had (to the extent not enforceable) never been contained in this Agreement. Notwithstanding the foregoing, if the value of this Agreement based on the substantial benefit of the bargain for any party is materially impaired, which determination as made by the presiding court or arbitrator of competent jurisdiction shall be binding, then both parties agree to substitute such provision(s) through good faith negotiations.

9.4. *Notices.* Any and all notices required or permitted to be given to a party pursuant to the provisions of this Agreement shall be in writing and shall be effective and deemed to provide such party sufficient notice under this Agreement on the earliest of the following: (i) at the time of personal delivery, if delivery is in person; (ii) at the time of transmission by facsimile, addressed to the other party at its facsimile number specified below the signature lines of this Agreement (or hereafter modified by subsequent notice to the parties hereto), with confirmation of receipt made by both telephone and printed confirmation sheet verifying successful transmission of the facsimile; (iii) _ _[*e.g., 1*]_ _ business day after deposit with an express

overnight courier for United States deliveries, or _ _[*e.g., 2*]_ _ business days after such deposit for deliveries outside of the United States, with proof of delivery from the courier requested; or (iv) _ _[*e.g., 3*]_ _ business days after deposit in the United States mail by certified mail (return receipt requested) for United States deliveries.

All notices for delivery outside the United States shall be sent by express courier. All notices not delivered personally shall be sent with postage and/or other charges prepaid and properly addressed to the party to be notified at the address set forth below the signature lines of this Agreement, or at such other address as such other party may designate by one of the indicated means of notice herein to the other parties hereto. Notices to the Company shall be marked "Attention: President."

9.5. *Independent Contractors.* The parties to this Agreement are independent contractors. There is no relationship of partnership, joint venture, employment, franchise, or agency between the parties. Except as expressly provided in this Agreement, neither party shall have the power to bind the other or incur obligations on the other's behalf without the other's prior written consent.

9.6. Amendment and Waivers. This Agreement may be amended only by a written agreement executed by each of the parties hereto. No amendment, waiver, or modification of any obligation under this Agreement shall be enforceable unless set forth in a writing signed by the party against which enforcement is sought. Any amendment effected in accordance with this section shall be binding on all parties hereto and each of their respective successors and assigns. No delay or failure to require performance of any provision of this Agreement shall constitute a waiver of that provision as to that or any other instance. No waiver granted under this Agreement as to any one provision herein shall constitute a subsequent waiver of such provision or of any other provision herein, nor shall it constitute the waiver of any performance other than the actual performance specifically waived.

9.7. *Entire Agreement.* This Agreement and the documents referred to herein constitute the entire agreement and understanding of the parties with respect to the subject matter of this Agreement, and supersede all prior understandings and agreements, whether oral or written, between or among the parties hereto with respect to the specific subject matter hereof.

9.8. *Titles and Headings.* The titles, captions, and headings of this Agreement are included for ease of reference only and shall be disregarded in interpreting or construing this Agreement. Unless otherwise specifically stated, all references herein to "sections" and "exhibits" shall mean "sections" and "exhibits" to this Agreement.

9.9. *Counterparts*. This Agreement may be executed in any number of counterparts, each of which when so executed and delivered shall be deemed an original, and all of which together shall constitute one and the same agreement.

9.10. *Facsimile Signatures.* This Agreement may be executed and delivered by facsimile, and on such delivery the facsimile signature shall be deemed to have the same effect as if the original signature had been delivered to the other party. The original signature copy shall be delivered to the other party by express overnight delivery. The failure to deliver the original signature copy and/or the nonreceipt of the original signature copy shall have no effect on the binding and enforceable nature of this Agreement.

IN WITNESS WHEREOF, the parties have executed this Domain Name Transfer Agreement as of the Effective Date.

Date: _ _ _ _ _ _ **Seller:**
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ **Buyer:**
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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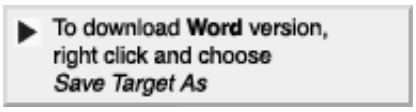
IV. TRANSITION SERVICES AGREEMENTS

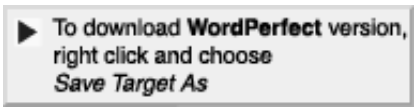
§8.21 A. Introduction

In many business transactions, one of the parties cannot immediately gain certain benefits or divest itself of certain obligations relating to the assets transferred. For example, a company may wish to sell part of its business, but it may have a multi-year information technology contract with a third party partner that cannot be divided along with the contemplated divestiture. In these circumstances, it is typical for the parties to enter into a transition services agreement to address the transitional requirements of the companies involved. A sample transition services agreement is presented in §8.22.

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§8.22 B. Form: Transition Services Agreement





8.22-1 Transition services agreement

TRANSITION SERVICES AGREEMENT

This Transition Services Agreement and its schedules (collectively, this "TSA") is made and entered into as of _ _[*date*]_ _ (the "Effective Date"), between _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation ("FirstCo"), and _ _[*name*]_ _, a _ _[*e.g., Delaware*]_ _ corporation ("SecondCo").

RECITALS

A. FirstCo will receive from SecondCo, and SecondCo will transfer to FirstCo, assets and liabilities relating to SecondCo's operations, on the terms and conditions set forth in the Asset Transfer Agreement between the parties dated _ _[*date*]_ _ (the "ATA"), to which this TSA is an Exhibit; and

B. To support the transfer, FirstCo desires to receive, and SecondCo agrees to provide to FirstCo, certain Services (as defined in Section 1.1) for a limited transition period on the terms and conditions set forth in this TSA.

AGREEMENT

NOW, THEREFORE, in consideration of the premises, the mutual agreements contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

1. DEFINITIONS

1.1. "Services" means the services specified in Schedule 2.

1.2. "FirstCo Site" means the website at _ _[*website URL*]_ _.

1.3. "FirstCo Marks" shall have the meaning set forth in Section 3.

1.4. "FirstCo Materials" means any content available at the FirstCo Site.

1.5. "Term" shall have the meaning set forth in Section 4.1.

2. SERVICES

2.1. *Provision of Services.* SecondCo agrees to provide to FirstCo the Services during the periods and on the terms and conditions specified in this TSA and its Schedule 2.

2.2. *Cooperation.* The parties shall use good faith efforts to cooperate with each other in all matters relating to the provision and receipt of the Services. Such cooperation shall include exchanging information, providing necessary access to people, equipment, and systems, and obtaining and providing all consents, licenses, sublicenses, and approvals necessary to enable each party to perform its obligations hereunder. The parties shall also cooperate in making information available as needed in the event of a tax audit, whether in the United States or any other country, during the Term and for _ _[*e.g., 10*]_ _ years following the expiration or termination of this TSA.

2.3. *Independent Contractor.* SecondCo shall provide the Services as an independent contractor, and

the employees or agents of SecondCo providing such Services shall remain employees or agents of SecondCo. SecondCo shall use its discretion in performing the Services, and shall determine its work location, hours, and rules.

2.4. ***FirstCo Customer Payments.*** **SecondCo shall pay to FirstCo any revenue or payments received by SecondCo from any customer paying for access to any FirstCo Site or any FirstCo Materials. Payments shall be due and payable within _ _[*e.g., 30*]_ _ days after the end of any calendar month during which each such customer payment is received. Payments shall be accompanied by a report detailing the source, date, and background of each customer payment.**

2.5. ***Fees for Services.*** **FirstCo shall pay SecondCo the fees described in Schedule 3.2 for the provision of Services and Deliverables. FirstCo shall also reimburse SecondCo for any reasonable and customary out-of-pocket expenses, including but not limited to travel and lodging expenses, incurred by SecondCo in connection with performing any Services under this TSA. At FirstCo's request, SecondCo shall furnish FirstCo with receipts and other documentation for all such expenses. All such fees and expenses shall be due and payable within _ _[*e.g., 30*]_ _ days after the date of SecondCo's invoice. Interest shall accrue on any overdue amounts owed by FirstCo at the lesser of _ _[*e.g., 1%*]_ _ per month or the maximum rate permitted by applicable law.**

3. LICENSE TO MARKS

FirstCo hereby grants to SecondCo a nonexclusive, nontransferable, worldwide license to use any FirstCo logos, trademarks, or service marks ("FirstCo Marks") that are provided to SecondCo by FirstCo, solely for purposes of performing its obligations under this TSA. SecondCo shall obtain FirstCo's prior written approval of any specific proposed use of FirstCo Marks.

4. TERM AND TERMINATION

4.1. ***Term.*** **Unless earlier terminated in accordance with Section 4.2 or Section 4.3, this TSA shall be effective beginning on the Effective Date and for a period of _ _[*number of months or years*]_ _ thereafter (the "Term").**

4.2. ***FirstCo Termination.*** **FirstCo may terminate this TSA, or any subpart of it (other than payment obligations to SecondCo), in its sole discretion on no less than _ _[*e.g., 10*]_ _ days' written notice to SecondCo.**

4.3. ***SecondCo Termination.*** **SecondCo may terminate this TSA, or any subpart of it, in the event of an acquisition, purchase of all or substantially all of its assets, or change of control, in its sole discretion on no less than _ _[*e.g., 90*]_ _ days' written notice to FirstCo.**

5. SURVIVAL

Sections _ _[*specify section numbers*]_ _ shall survive any expiration or termination of this TSA.

6. PROPRIETARY AND CONFIDENTIAL INFORMATION

6.1. ***Definition of Confidential Information.*** **"Confidential Information" means (i) any proprietary information of either party disclosed in writing and conspicuously designated as "Confidential" at the time of disclosure or disclosed orally, identified as "Confidential" at the time of disclosure, and summarized in a writing sent by the disclosing party to the receiving party within _ _[*e.g., 30*]_ _ days of any such disclosure, (ii) the terms and conditions of this Agreement, and (iii) any information that a party received by virtue of its prior existing unity with the other party that would reasonably under the circumstances be considered confidential and valuable at least in part due to its confidential nature.**

6.2. ***Exclusions.*** **Confidential Information shall not include any information that (i) is or becomes generally known to the relevant public through no fault of the receiving party; (ii) the receiving party can demonstrate by written evidence rightfully came into its possession after the Effective Date, without an obligation of confidentiality; (iii) the receiving party can demonstrate by written evidence was independently developed after the Effective Date by the receiving party without access to the disclosing party's Confidential Information; or (iv) the receiving party rightfully obtains from a third party without any duty of confidentiality.**

6.3. *Confidentiality Obligation.* Each party shall maintain the confidentiality of the other party's Confidential Information for _ _[*e.g., 7*]_ _ years after receipt by taking reasonable protective measures but not less than the measures it uses for its own Confidential Information of similar importance; and during that period, neither party shall use the other party's Confidential Information for any purpose other than to accomplish the purpose of this Agreement. Each party is permitted to disclose the other party's Confidential Information to its employees and contractors but only to the extent that such employees and contractors need to know the Confidential Information to accomplish the purpose of this Agreement, and only after any such employee or contractor has agreed in writing to obligations at least as protective of the original disclosing party's Confidential Information as those set forth in this Section 6.3. The receiving party may disclose Confidential Information of the other party to the extent required by law, but only if the receiving party provides prompt written notice to enable the disclosing party to seek a protective order or otherwise restrict the disclosure. Each party may disclose the terms and conditions of this Agreement on a confidential basis to its legal and financial advisors and to its existing or potential private investors or acquirers. Each party shall treat this Agreement's terms as the other's Confidential Information, provided, however, that each party is entitled to disclose to its contractors pertinent portions of the terms and conditions of this Agreement except prices and payment terms. Each receiving party shall promptly comply with any written request to return or destroy all or part of the other's Confidential Information and all copies thereof, and certify its compliance in writing.

7. LIMITATION ON LIABILITY

EXCEPT FOR LIABILITY ARISING UNDER SECTION _ _[*specify section number*]_ _, UNDER NO CIRCUMSTANCES SHALL EITHER PARTY BE LIABLE TO THE OTHER FOR ANY INDIRECT, INCIDENTAL, OR CONSEQUENTIAL DAMAGES OR LOST PROFITS ARISING UNDER THIS TSA (WHETHER BASED ON BREACH OF CONTRACT, TORT (INCLUDING NEGLIGENCE), STRICT LIABILITY, OR OTHER LEGAL OR EQUITABLE THEORY) IRRESPECTIVE OF WHETHER SUCH PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGE. THIS SECTION 7 DOES NOT LIMIT EITHER PARTY'S LIABILITY FOR BODILY INJURY OR PHYSICAL DAMAGE TO PROPERTY. EXCEPT WITH RESPECT TO CLAIMS OF DEFAMATION OR INTELLECTUAL PROPERTY INFRINGEMENT OR MISAPPROPRIATION, THE LIABILITY OF EITHER PARTY FOR DAMAGES OR ALLEGED DAMAGES HEREUNDER, WHETHER IN CONTRACT, TORT, OR ANY OTHER LEGAL THEORY, IS LIMITED TO, AND SHALL NOT EXCEED, THE AMOUNTS DUE UNDER THIS TSA.

8. MISCELLANEOUS

8.1. *Force Majeure.* Neither party shall be liable to the other for delays or failures in performance resulting from causes beyond the reasonable control of that party, including, but not limited to, acts of nature, labor disputes or disturbances, material shortages or rationing, riots, acts of war, governmental regulations, public communication systems or utility failures, or casualties. In the event SecondCo is prevented from fulfilling any obligation hereunder due to such an event, SecondCo shall resume performance under this TSA immediately after the delaying cause ceases and, at FirstCo's option, extend the Term for a period equivalent to the length of time the excused delay endured.

8.2. *Compliance With Laws.* The Parties hereby assure and certify that they will not directly or indirectly, import, export, re-export, or transship the Products or related information, media, or products to any country or foreign person in violation of United States or any other applicable country's laws and regulations, and the exporting party will obtain all licenses and approvals, if required. Each party unconditionally accepts full responsibility for compliance with the requirements set forth in this Section 8.2. FirstCo represents and warrants that it has continuously complied and is in compliance, and FirstCo agrees to comply, with all laws, rules, and regulations regarding _ _[*describe business*]_ _ in any jurisdiction in the world; FirstCo shall indemnify and hold SecondCo harmless from and against all third party claims and legal enforcement actions related to FirstCo's _ _[*describe business*]_ _ business.

8.3. *Relationship of Parties.* The parties are independent contractors under this TSA and no other relationship is intended, including without limitation a partnership, franchise, joint venture, agency, employer/employee, fiduciary, or other special relationship. Neither party shall have any right or authority to assume, create, or incur any liability or any obligation on behalf of the other party. Neither party shall take any action that expresses or implies a relationship other than that of independent contractor.

8.4. *No Third Party Beneficiaries.* Unless otherwise expressly provided, no provisions of this TSA are

intended or shall be construed to confer on or give to any person or entity other than FirstCo and SecondCo (and their permitted successors and assigns) any rights, remedies, or other benefits under or by reason of this TSA.

8.5. *Equitable Relief.* Each party acknowledges that a breach by the other party of any confidentiality or proprietary rights provision of this TSA may cause the nonbreaching party irreparable damage, for which the award of damages would not be adequate compensation. Consequently, the nonbreaching party may institute an action to enjoin the breaching party from any and all acts in violation of those provisions, which remedy shall be cumulative and not exclusive, and a party may seek the entry of an injunction enjoining any breach or threatened breach of those provisions, in addition to any other relief to which the nonbreaching party may be entitled at law or in equity.

8.6. *Notices.* All notices, requests, demands, waivers, consents, or other communications required or permitted hereunder shall be in writing and be deemed to have been duly given when given in the manner and to the address set forth in Section _ _[*specify section number*]_ _ of the ATA.

8.7. *Assignment.* SecondCo may not assign its rights or delegate its obligations hereunder, either in whole or in part, whether by operation of law or otherwise, without the prior written consent of FirstCo. Any attempted assignment or delegation without FirstCo's written consent shall be void. Subject to the foregoing, the rights and liabilities of the parties under this TSA shall bind and inure to the benefit of the parties' respective successors and permitted assigns.

8.8. *Waiver and Modification.* Failure or delay by either party to enforce any provision of this TSA shall not be deemed a waiver of future enforcement of that or any other provision. Any waiver, amendment, or other modification (either generally or in a particular instance, either retroactively or prospectively and either for a specified period of time or indefinitely) of any provision of this TSA shall be effective only if in writing and signed by the parties.

8.9. *Severability.* If for any reason a court of competent jurisdiction finds any provision of this TSA to be invalid, illegal, or unenforceable, that provision of the TSA shall be enforced to the maximum extent permissible so as to give effect to the intent of the parties, and the remainder of this TSA shall continue in full force and effect.

8.10. *Controlling Law and Jurisdiction.* This TSA and any action related thereto shall be governed and interpreted by the laws of the State of California, without regard to its conflicts-of-laws principles, as such laws are applied to agreements between California residents entered into and to be performed entirely in California. The exclusive jurisdiction and venue of any action with respect to the subject matter of this TSA shall be the superior court of the State of California for the County of _ _[*specify county*]_ _ or the United States District Court for the _ _[*specify federal judicial district*]_ _ District of California and each party hereby waives any objection to the exclusive jurisdiction and venue of such courts for the purpose of any such action. The parties specifically disclaim the applicability of the UN Convention on Contracts for the International Sale of Goods.

8.11. *Headings.* Headings used in this TSA are for ease of reference only and shall not be used to interpret any aspect of this TSA. Except as otherwise indicated, all references in this TSA to sections and schedules refer to sections and schedules of this TSA.

8.12. *Entire Agreement.* Subject to Section 8.14, this TSA, including its schedules, constitutes the entire agreement between the parties with respect to the Services, and supersedes and replaces all prior and contemporaneous understandings or agreements, written or oral, regarding such subject matter.

8.13. *Counterparts.* This TSA may be executed in two counterparts, each of which shall be an original and together which shall constitute one and the same instrument.

8.14. *No Effect on Asset Purchase Agreement.* Nothing in this TSA shall reduce, change, supersede, or replace any obligations of either party under the ATA.

IN WITNESS WHEREOF, the parties have executed this TSA as of _ _[*date*]_ _.

FirstCo:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

SecondCo:
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

SCHEDULE 2 TO TRANSITION SERVICES AGREEMENT

SERVICES AND SERVICE LEVELS

[Description of services and service levels]

SCHEDULE 3.2 TO TRANSITION SERVICES AGREEMENT

FEES

[Schedule of fees]

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V. INTELLECTUAL PROPERTY LICENSES

§8.23 A. Generally

For a variety of reasons, companies who are parties to a merger or acquisition transaction may decide to license or cross-license technology instead of transferring ownership of the technology outright. The principal business reasons for licensing intellectual property rights rather than acquiring them outright are discussed in chap 3. See §§3.28-3.33. Intellectual property licenses are discussed in detail in chap 5. Sections 8.24-8.32 address a series of special types of intellectual property licenses that may be encountered in due diligence or otherwise in merger and acquisition transactions.

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B. Special-Use Licenses

1. Escrow Agreements

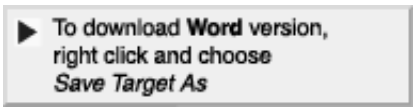
§8.24 a. Introduction

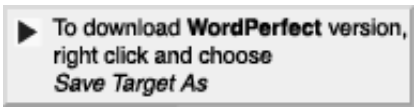
The existence of legacy escrow agreements may be disclosed in due diligence investigations, and many business transactions will require technology escrows to protect one of the parties from certain contingencies. Most common are source code escrows, in which a company may prevent disclosure of its computer program source code unless a particular set of circumstances arises. For example, large customers may be able to demand source code should the company be unable or unwilling to fix an operational problem with a software program. While other types of escrow agreements are common, such as escrows of funds to be paid only under certain circumstances (see §7.8), the example in §8.25 is an escrow relating to intellectual property. Many escrow agents provide their own forms of agreement for use by their customers. Examples of these can be obtained on the Internet or from the proposed escrow agent. The example provided in §8.25, styled as an attachment to a larger agreement, contemplates that the parties will employ a commercial source code escrow service.

For further discussion and another form of source code escrow agreement, see Internet Law and Practice in California, chap 15 (Cal CEB 2004). Issues concerning source code escrows that may arise in bankruptcy proceedings are discussed in §§12.36-12.40 and 12.80-12.81.

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§8.25 b. Form: Source Code Escrow Agreement





8.25-1 Source code escrow agreement

SOURCE CODE ESCROW

1. *Escrow Agreement.* Within _ _[*e.g., 60*]_ _ days of commencement of the full license as described in Section _ _ of the Master Agreement, Software Company, Inc. shall register such Licensee as a beneficiary under a source code escrow agreement between Software Company, Inc. and a commercially recognized third party escrow agent doing business in California that provides for the deposit by Software Company, Inc. of copies of the source code for the Software and related supporting documentation and materials, including any updates provided hereunder (collectively, the "Deposit Materials"). Licensee shall pay all fees incurred by Software Company, Inc. in connection with the establishment and maintenance of the escrow account under the Escrow Agreement.

2. *Release Conditions.* In the event that Software Company, Inc. fails to provide maintenance and support substantially in conformity with the Agreement concerning Maintenance and Upgrades, Licensee shall be entitled to seek release of the Deposit Materials following written notice of such failure, and Software Company Inc.'s failure to cure such default within _ _[*e.g., 30*]_ _ days of such notice, and provided the Licensee seeking such release is not itself in breach of the Agreements.

3. *Escrow License Conditions.* In the event the Deposit Materials are released to Licensee pursuant to Section 2 above, Licensee shall have a nonexclusive, nontransferable, nonsublicensable right and license to use, copy, and modify the Deposit Materials for the limited purpose of providing support and maintenance equivalent to the support and maintenance services that Software Company, Inc. agreed to provide to Licensee under the agreements between the parties.

4. *Nondisclosure.* Licensee shall not disclose, release, or otherwise make the Deposit Materials available to any third party without the prior written consent of Software Company, Inc.

5. *Consultants.* Licensee has the right to retain any independent consultant it chooses to visually inspect the Deposit Materials to ensure that Software Company, Inc. complies with the terms of this Source Code Escrow Agreement. Notwithstanding the foregoing, Licensee shall not retain as a consultant for this purpose any software developer or vendor that designs, licenses, or offers for sale software products that offer similar functionality and features as the Software.

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2. University Technology Transfer Licenses

§8.26 a. Introduction

Many companies license technology used in their products from university technology transfer offices. These are often but not always exclusive licenses, and deserve review as if they were outright transfers of ownership. One feature common in university-sourced technology is that the federal government may have a license and other rights in the technology developed under federal grants. Accordingly, university licenses often contain corresponding restrictions (known as "Bayh-Dole" provisions after the Bayh-Dole Act, 35 USC §200) that need to be considered in reviewing these licenses. A typical form of university technology license is presented in §8.27.

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§8.27 b. Form: University License Agreement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

8.27-1 University license agreement

LICENSE AGREEMENT

This License Agreement ("Agreement") is made between the _ _[*name of university*]_ _, a California educational institution, whose address is _ _[*address*]_ _ ("University"), and _ _[*name*]_ _, a _ _[*e.g., California*]_ _ corporation, whose address is _ _[*address*]_ _ ("Licensee").

RECITALS

A. University owns the Licensed Subject Matter (as defined below), and wishes to have the Licensed Subject Matter protected by patents and used for the benefit of the inventors, University, and the public as outlined in the Patent Policy of University; and

B. Licensee desires to secure an exclusive license to the Licensed Subject Matter to practice the invention in the United States and all foreign countries.

AGREEMENT

NOW THEREFORE, in consideration of the mutual covenants and promises herein contained, the parties agree as follows:

1. *Effective Date.* This Agreement shall be effective as of _ _[*date*]_ _.

2. *Definitions.* As used in this Agreement, the following terms shall have the meanings indicated:

2.1. "Licensed Field" shall mean all applications within the Licensed Subject Matter (as defined below).

2.2. "Licensed Product(s)" shall mean any product(s) covered by one or more claims of the Patents (as defined below) or produced by a method covered by one or more of the claims of the Patents, or utilizing any Licensed Subject Matter.

2.3. "Licensed Subject Matter" shall mean certain Technology (as defined below) known as "_ _[*title of invention*]_ _" and more specifically described in Schedule A to this Agreement, together with all compounds, processes, data, and information relating to Technology provided by University to Licensee prior and subsequent to this Agreement.

2.4. "Patent Rights" shall mean University's rights under those United States and foreign patents and patent applications obtained or filed by University or Licensee acting for University, including any division, continuation, continuationinpart, or reissue thereof, or substitute therefor, and the letters patent that may be issued thereon.

2.5. "Patents" shall have the meaning set forth in Section 5.

2.6. "Sale(s)" or "Sold" shall mean any disposition of a Licensed Product for value to a party other than Licensee or a sublicensee of Licensee.

2.7. "Gross Sales" shall mean Licensee's billings (not less than cost) on Sales of Licensed Products and any components or replacement parts therefor, less any customary discounts allowed and actually taken, sales or use tax, import or export duties or their equivalent, outbound transportation prepaid or allowed,

insurance, installation charges or charges for extended warranty or service contracts, amounts allowed or credited due to returns (not exceeding the original billing), and the imputed interest factor under any lease. Gross Sales shall not be reduced due to commissions, taxes, other than sales or use taxes, or import or export duties.

2.8. "Technology" shall mean any invention, discovery, knowhow, process, procedure, method, protocol, formula, technique, software, design, drawing, data, or other valuable technical information.

2.9. "Technology Rights" shall mean the rights to maintain Technology in confidence and to prevent others, under the law of unfair competition, from appropriating such Technology.

3. *Marketing Efforts*

3.1. Licensee shall use reasonable efforts, as defined herein, to effect assiduously the introduction of Licensed Products into the commercial market as soon as practicable. Such efforts may include, but shall not be limited to: (i) sufficient funding to University to continue research efforts at a rate mutually agreed to by Licensee and University; (ii) launching a product in a North American or European market within _ _[*e.g., 2*]_ _ years of the Agreement date.

3.2. On request of University, but not more often than once per calendar year, Licensee shall deliver to University a written report as to Licensee's efforts and accomplishments during the preceding year in commercializing Licensed Products in various parts of the licensed territory and its commercialization plans for the upcoming year.

4. *Warranty.* University represents and warrants that it is the owner of the entire right, title, and interest in and to Technology, that it has the sole right to apply for patents on Technology and to grant licenses under such patents and Technology, and that it has not granted licenses thereunder to any other person.

5. *Patents.* University shall file applications for patents on Technology related to the Licensed Subject Matter ("Patents") in the United States and foreign countries, as mutually agreed between University and Licensee. Licensee shall pay all costs relating to the filing, prosecuting, and maintaining of the Patents exclusively licensed hereunder and shall pay all such future expenses so long as and in such countries as its license remains exclusive. In any country in which University desires patent protection but in which Licensee does not desire to pay the expenses thereof, the license granted hereunder in such country shall become nonexclusive.

6. *License*

6.1. University hereby grants to Licensee a worldwide exclusive license to the Patents and the Licensed Subject Matter, under its Patent Rights and Technology Rights, to make, have made for it, use, and sell Licensed Products in the Licensed Field during the Term of this Agreement.

6.2. Licensee shall have the right to grant sublicenses consistent with this Agreement provided that Licensee shall be responsible for the operations of its sublicensees relevant to this Agreement as if such operations were carried out by Licensee, including the payment of royalties whether or not paid to Licensee by the sublicensee. Licensee further agrees to deliver to University a true and correct copy of each sublicense granted by Licensee, and any modification or termination thereof, within _ _[*e.g., 30*]_ _ days after execution, modification, or termination. On termination of this Agreement, any and all existing sublicenses granted by Licensee shall be assigned to University.

6.3. The parties recognize that Licensee may encounter patents held by third parties that are superior to both University's and Licensee's patents and that a crosslicense between Licensee and such third party may be necessary to enable Licensee to market Licensed Products. In such event Licensee has the right to enter into crosslicensing agreements with third parties and to grant crosslicenses under any and all of the patents, provided:

(a) University is consulted beforehand and is reasonably satisfied that the third party does in fact hold a patent that limits Licensee's competitiveness in marketing Licensed Products;

(b) The rights received by Licensee under such a crosslicensing agreement cover only Licensed Products and are not directed to other products;

(c) University incurs no financial or legal liabilities under the crosslicense;

(d) Any money or the value of any equipment received by Licensee in exchange for such crosslicense is treated as Gross Sales for Licensed Product; and

(e) The crosslicense provides that University has the option of terminating any rights thereunder for any reason.

Nothing in this Section 6.3 shall prevent Licensee from granting a sublicense under Section 6.2 of this Agreement.

6.4. University specifically retains the right to: (a) publish the general scientific findings from research related to Patents and Technology, and (b) use Patents and Technology for research, teaching, and other University purposes.

6.5. University shall have the right at any time after _ _[*e.g., 5*]_ _ years from the date of this Agreement to terminate the exclusivity of the license granted herein if Licensee, within _ _[*e.g., 90*]_ _ days after written notice from University of such intended termination of exclusivity, fails to provide written evidence that it has commercialized or is actively attempting to commercialize an invention hereunder, and shall have the right at any time after _ _[*e.g., 6*]_ _ years from the date of this Agreement to terminate the license completely if Licensee within _ _[*e.g., 90*]_ _ days after written notice from University of such intended termination fails to provide written evidence that it has commercialized or is actively attempting to commercialize an invention licensed hereunder. Evidence provided by Licensee that it has an ongoing and active research, developmental, manufacturing, marketing, or licensing program as appropriate, directed toward production and sale of products based on the invention disclosed and claimed in patents or incorporating Technology, shall be deemed satisfactory evidence.

6.6. After _ _[*e.g., 5*]_ _ years from the date of this Agreement, University shall have the right, on _ _[*e.g., 30*]_ _ days' prior written notice, to reduce the license granted hereunder to nonexclusive in any national political jurisdiction in which Licensee has failed to commercialize or continue to commercialize a Licensed Product.

6.7. During the term of this Agreement and for a period of _ _[*e.g., 5*]_ _ years thereafter, Licensee shall not disclose any Technology to third parties without the express written consent of University except to the extent that such Technology: (a) is or later becomes part of the public domain through no fault of Licensee; (b) was in the possession of Licensee prior to receipt from University; (c) is received from a third party having no obligations of confidentiality to University; or (d) is sublicensed under the terms of this Agreement. This provision shall survive termination of this Agreement.

7. *Payments and Reports*

7.1. On execution of this Agreement, Licensee shall pay University the sum of $_ _[*amount*]_ _ as an advance against future royalties.

7.2. Licensee shall pay University a royalty of _ _[*number*]_ _ percent of its Gross Sales, and _ _[*number*]_ _ percent of the Gross Sales of its sublicensees. Such royalty shall be due for the calendar quarter in which the Licensed Product is delivered.

7.3. During the term of this Agreement and for _ _[*e.g., 1*]_ _ year thereafter, Licensee shall keep complete and accurate records of its and its sublicensees' Sales of Licensed Products under the license granted in this Agreement in sufficient detail to enable the royalties payable hereunder to be determined. Licensee shall permit University or its representatives, at University's expense, to periodically examine its books, ledgers, and records during regular business hours for the purpose of verifying, and to the extent necessary to verify, any report required under this Agreement. In the event that the difference between the amount of royalty due and the amount of royalty actually paid exceeds _ _[*number*]_ _ percent, Licensee shall pay the cost of such examination.

7.4. Within _ _[*e.g., 30*]_ _ days after March 31, June 30, September 30, and December 31, Licensee shall deliver to University a true and accurate report, giving such particulars of the business conducted by

Licensee and its sublicensees, if any exist, during the preceding 3 calendar months under this License Agreement as are pertinent to an accounting for royalty payments hereunder. Such report shall include at least (a) the quantities of Licensed Products that it has Sold; (b) the billings thereon that comprise Gross Sales; (c) the calculation of royalties thereon; and (d) the total royalties so computed and due University. Simultaneously with the delivery of each such report, Licensee shall pay to University the amount, if any, due for the period of such report. If no payments are due, it shall be so reported.

7.5. All amounts payable hereunder by Licensee shall be payable in United States funds without deductions for taxes, assessments, fees, or charges of any kind.

8. *Term and Termination*

8.1. The term of this Agreement shall extend from the Effective Date set forth above to the full end of the term or terms for which the Patents or extensions thereof are granted (determined on a countrybycountry basis) or if no patents are the subject of this agreement, for a term of _ _[*e.g., 10*]_ _ years.

8.2. This Agreement shall terminate earlier: (a) automatically if Licensee shall become bankrupt or insolvent or if the business of Licensee is placed in the hands of a receiver, assignee, or trustee, whether by voluntary act of Licensee or otherwise; and (b) on _ _[*e.g., 90*]_ _ days' written notice if Licensee shall breach or default on any obligation under this License Agreement; provided, however, that Licensee may avoid such termination if before the end of such period Licensee notifies University that such breach has been cured and states the manner of such cure.

8.3. On termination of this Agreement for any cause, nothing herein shall be construed to release either party of any obligation matured prior to the effective date of such termination, and Licensee may, after the effective date of such termination, sell all Licensed Products and parts therefor that it may have on hand at the date of termination, provided that it pays earned royalty thereon as provided in this Agreement.

9. *Infringement*

9.1. Licensee shall have the obligation of enforcing at its expense any patent exclusively licensed hereunder against infringement by third parties and shall be entitled to retain any recovery from such enforcement. Licensee shall pay University royalty on any monetary recovery to the extent that such monetary recovery by Licensee exceeds its expenses. In the event that Licensee does not file suit against a substantial infringer of such patents within _ _[*e.g., 6*]_ _ months of knowledge thereof, then University shall have the right to reduce the license granted hereunder to nonexclusive.

9.2. In any suit or dispute involving an infringer, the parties shall cooperate fully, and on the request and at the expense of the party bringing suit, the other party shall make available to the party bringing suit all relevant records, papers, information, samples, specimens, and the like that may be relevant and in its possession.

10. *Assignment.* This Agreement may not be assigned by Licensee without the prior written consent of University; provided that Licensee may assign this Agreement to any purchaser or transferee of all or substantially all of Licensee's business upon prior written notice to University.

11. *Patent Marking.* Licensee agrees to mark permanently and legibly all Licensed Products manufactured or sold by it under this Agreement with the number of each issued Patent applicable thereto.

12. *Indemnification.* Licensee shall indemnify and save University from and against any and all liability for injury to persons or property occasioned wholly or in part by any Licensed Product or by act or omission of Licensee, its sublicensees, agents, or employees, including any and all expenses, legal or otherwise, incurred by University in the defense of any claim or suit related thereto.

13. *Attorney Fees.* In the event that either party initiates any action at law, whether in court or otherwise, against the other which is in any way connected with this Agreement, or intervenes in any action or proceeding wherein the other is a party, in order to enforce or protect its interest or rights hereunder, the party prevailing in any such action shall recover and receive from the other party reasonable attorney fees and court costs, in connection with any such action, or any appeal thereof.

14. *General Provisions*

14.1. This Agreement constitutes the entire and only agreement between the parties related to the Patents and Licensed Subject Matter, and all prior negotiations, representations, agreements, and understandings are superseded hereby. No agreements altering or supplementing the terms hereof may be made except by means of written documents signed by the duly authorized representatives of the parties.

14.2. Any notice required by this License Agreement shall be given by prepaid, first-class, certified mail, return receipt requested, addressed in the case of University to:

_ _[*Name*]_ _
_ _[*Title*]_ _
_ _[*Address*]_ _

and in the case of the Licensee to:

_ _[*Name*]_ _
_ _[*Title*]_ _
_ _[*Address*]_ _

or such other addresses as may be given from time to time under the terms of this notice provision.

14.3. This License Agreement shall be construed and enforced in accordance with the laws of the State of California, without regard to its conflict of law provisions, and venue for actions relating hereto shall lie in California.

14.4. Any failure of University to enforce a right under this Agreement shall not act as a waiver of that right or the ability to later assert that right relative to the particular situation involved.

14.5. Headings included herein are for convenience only and shall not be used to construe this Agreement.

14.6. If any provision of this Agreement shall be found by a court to be void, invalid, or unenforceable, the same shall either be reformed to comply with applicable law or stricken if not so conformable, so as not to affect the validity or enforceability of this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused their duly authorized representatives to execute this Agreement.

Date: _ _ _ _ _ _

University:
_ _[*Name of university*]_ _,
a _ _[*type of legal entity*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

Licensee:
_ _[*Name of corporation*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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3. Government Rights Issues

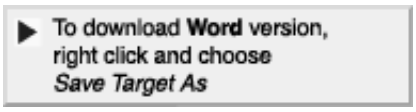
§8.28 a. Introduction

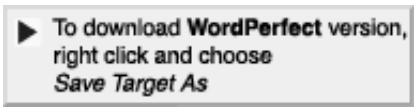
A number of special issues come into play when companies work with the federal government. For example, the Federal Acquisition Regulation Supplement (FARS) (48 CFR §§1.101-53.303-WH-347) and the Defense Federal Acquisition Regulation Supplement (DFARS) (48 CFR §§201.104-253.215-70) apply to contracts with the federal government and the U.S. Department of Defense, respectively, and may have a significant and unanticipated impact on a target company's operations.

One common example concerns the need to identify software or other technology sold to the government as subject to "restricted rights"—otherwise the government may be able to exercise unlimited rights with respect to the software, *e.g.,* disclosing trade secrets embodied in the software. An example of a typical restricted rights provision in a value-added reseller (VAR) agreement between a software company and the government is set forth in §8.29. The indented clause is an example of what the regulations allow the company to include in subsequent distribution agreements that the company makes with third parties, such as end users. The form in §8.30 is a slightly different example of what the company might include in its end-user agreements, to assure that any end user that is a governmental agency (or a government contractor) and that obtains the product will be on notice that it does not have unlimited rights to the product. Both provisions are examples of how the regulations allow software companies to require the government to respect the company's trade secrets and other intellectual property rights, in the same way that nongovernmental end users can be required to do. See generally 48 CFR §§12.212, 52.227-14, 52.227-19.

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§8.29 b. Form: Restricted Rights Legend





8.29-1 Restricted rights legend

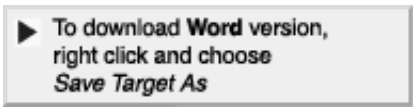
Government Rights. **VAR may distribute the Software and Technology to the U.S. Government or to End Users under U.S. Government contracts if and only if VAR: (i) informs such government end users in writing and prior to distribution that the Software and Technology are "commercial software" and "commercial technical data" as defined in DFARS 252.227-7015 and FAR 12.211, and (ii) includes in any end-user license agreement or other relevant agreement the following written notice:**

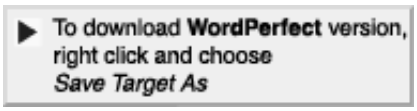
> **The Software and Technology provided hereunder are Commercial Software and Commercial Technical Data as defined in DFARS 252.227-7015 and FAR 12.211. Any use, modification, reproduction, release, distribution, performance, display, or disclosure of the Software or Technology shall be in strict accordance with the manufacturer's standard commercial license or the terms and conditions of this Agreement, as applicable, as provided in DFARS 227.7202-1(a) and 227.7202-3(a) (1995), DFARS 252.227-7013(c)(1)(ii) (Oct. 1988), DFARS 252.227-7015, FAR 12.212(a) (1995), FAR 52.227-19, or FAR 52.227-14 (ALT III), as applicable. The manufacturer is: _ _[*licensor name and address*]_ _.**

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.30 c. Form: End-User Legend

§8.30 c. Form: End-User Legend





8.30-1 End-user legend

When licensed to the U.S. Government or to an end user under a contract with the U.S. Government, all Software produced by _ _[*name*]_ _ is commercial computer software as defined in FAR 12.212 and has been developed exclusively at private expense. All technical data, commercial computer software, and documentation provided hereunder by _ _[*name*]_ _ is subject to the provisions of FAR 12.211—"Technical Data" and FAR 12.212—"Computer Software" respectively, or clauses providing _ _[*name*]_ _ equivalent protections in DFARS or other agency-specific regulations. Any use, modification, reproduction, release, distribution, performance, display, or disclosure of the technical data, commercial computer software, or documentation provided hereunder shall be in strict accordance with the manufacturer's standard commercial license. Manufacturer: _ _[*name and address*]_ _.

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§8.31 4. Open Source Licenses

Many software developers use at least some software components that are provided under so-called "open source" licenses. Open source licenses typically allow the public to access, modify, and redistribute the source code for the licensed software free of charge. In many instances, open source licenses also include a "viral" aspect in that they require the source code of derivative or collective works that include the licensed open source software to be made available publicly under similar open source terms. Some open source software licenses are restricted to noncommercial use and forbid use of the licensed software in products for commercial sale. In *Jacobsen v Katzer* (Fed Cir 2008) 535 F3d 1373, 1381, the Federal Circuit held that copyright holders who engage in open source licensing have the right to control the modification and distribution of their copyrighted material. For further discussion of open source licenses, see Murray, *Open Source: A Challenge Worth Meeting*, 24 CEB Cal Bus L Prac 105 (Fall 2009); Internet Law and Practice in California, chap 8 (Cal CEB 2004).

In due diligence investigations, it is critical to determine how much (if any) of the target company's software includes open source components or at least make an assessment of the target company's approach toward use of open source components. In general, an established commercial software company will not want the target company's use of open source elements to require public release of the source code for its own proprietary products.

One example of an open source license, often avoided by commercial enterprises because of its viral effect, is the GNU General Public License (GPL) form of license, available at http://www.gnu.org/licenses/.

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§8.32 5. Other "Emerging" Forms of Licenses

Intellectual property groups from time to time promulgate license forms that include features not present in common existing forms of IP licenses. For example, the Creative Commons website, at http://creativecommons.org/license/, posts a wide variety of license forms, including (1) a complete dedication of intellectual property rights to the public domain (really not a license but a general relinquishment of rights), (2) a "developing nations" form of license that provides a royalty-free copyright license in developing countries while retaining the copyright in the developed world, and (3) a "founder's copyright" license that reduces the term of protection down from the "life plus 70 years" term under current U.S. copyright laws to the 14-year original term plus 14-year renewal term that existed under the first U.S. copyright law in 1790. As time goes on and communities with special interests—in either protecting or freely distributing intellectual property rights—continue to develop, more and more nontraditional forms of licenses may be uncovered in commercial due diligence.

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§8.33 VI. LEGAL OPINIONS REGARDING INTELLECTUAL PROPERTY

Some merger and acquisition transactions trigger a request from one party or another for a legal or accounting opinion to be delivered on or before the closing of the transaction. Many closing opinions do not deal primarily with intellectual property—for example, a "fairness opinion" addresses whether the purchase price for the transaction is reasonable, based on a variety of issues that may or may not include the intellectual property position of the target company. Corporate legal opinions address the existence and good standing of, *e.g.,* the selling corporation, whether the contemplated transaction would conflict with that corporation's organizational documents or material agreements, whether there is any pending or threatened litigation, and similar matters. For further information on corporate legal opinions, see Corporations Committee, State Bar of California, Business Law Section, Legal Opinions in Business Transactions (Excluding the Remedies Opinion), 2005 Report (May 2005, rev'd Sept. 2007), and State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions (Sept. 2004, rev'd Jan. 2005), both of which are available at the State Bar website at http://www.calbar.ca.gov.

In some transactions, notably biotechnology deals, the acquiring company may wish to obtain a "freedom to operate" (FTO) or "product clearance" opinion from patent counsel, stating that the technology to be acquired does not infringe *any* third party rights. FTO opinions are broader than noninfringement opinions, which typically are limited to one or at most a few specific patents. In other industries, notably electronics and software, the nature of the technology may make an FTO opinion so qualified as to be of little value. For example, a computer manufacturer may be subject to patent claims ranging from disk drives to power supplies to display drivers. Sometimes, opinions are restricted to known competitors or known patent plaintiffs.

FTO opinions are often broader than conventional opinions from independent patent counsel and cover entire patent portfolios rather than a single patent. Unless the scope is precisely defined and the industry is such that infringement threats are relatively easy to identify, FTO opinions may be of little practical value. In addition, significant attorney-client privilege issues may arise because FTO opinions are typically obtained in connection with a company's operations well in advance of a proposed M&A transaction, and the acquiring company typically asks the selling company to release its FTO opinion to the acquirer. FTO opinions are therefore generally reserved for select situations where they can truly help provide visibility concerning the risks associated with the transaction. For further discussion of FTO analysis, see §4.23.

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VII. COPYRIGHT REGISTRATION

§8.34 A. Introduction

Unlike patent protection, copyright protection does not require registration or other governmental filing as a prerequisite. Under 17 USC §102(a), copyright protection exists "in original works of authorship fixed in any tangible medium of expression… from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device." Federal registration is required, however, before a copyright infringement suit can be brought, and prompt registration gives the copyright owner enhanced rights in litigation. See 17 USC §§408(a), 411(a), 412.

In due diligence investigations, determining whether copyrights have been registered and reviewing the registrations can reveal much about how a company's intellectual property has been developed and how well it has been protected. For example, a copyright registration may reveal whether a software package was developed entirely by the target company or if it has components derived from various contributing contract programmers.

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§8.34A B. Copyright Registration Procedures

If a company acquires unregistered copyrights, it may wish to register them soon after closing the acquisition transaction. The Copyright Office now recommends that applicants for registration use its online system, the Electronic Copyright Office (eCO), in the first instance as a faster, less expensive procedure that enables online status tracking and the ability to upload certain types of electronic files directly. For further information concerning eCO, see http://www.copyright.gov/eco/index.html and http://www.copyright.gov/eco/tips.pdf.

As its second preferred alternative for registration, the Copyright Office offers its fill-in Form CO, available at http://www.copyright.gov/forms/notice.html , which replaces the older Forms TX (literary works), VA (visual arts), PA (performing arts, including motion pictures), SR (sound recordings), and SE (single serials). Form CO is intended to be completed on-screen and then printed out for submission to the Copyright Office. It is programmed with special, scanable barcodes that embed the information that applicants type into the form, to enable the Copyright Office to process forms faster and more efficiently. The instructions for completing Form CO are posted at: http://www.copyright.gov/forms/formco2d-ins.pdf. A sample copy of Form CO is reproduced in §8.35.

As a third alternative for registration, the Copyright Office makes available by mail, on special request, paper versions of Forms TX (literary works), VA (visual arts), PA (performing arts, including motion pictures), SR (sound recordings), and SE (single serials).

NOTE: Certain special types of copyright applications, including group registrations, are subject to different procedures, detailed at http://www.copyright.gov/forms. In any case, counsel should check the Copyright Office website before filing any application for registration to assure that the most current version of the correct registration form is used.

For further general information about copyright and copyright registration, see the Copyright Office's publication, Copyright Office Basics, available at http://www.copyright.gov/circs/circ1.pdf.

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Source: Business Law/Intellectual Property in Business Transactions/8 Related Documents/§8.35 C. Form: United States Copyright Office Form CO

§8.35 C. Form: United States Copyright Office Form CO



UNITED STATES COPYRIGHT OFFICE

Form CO · Application for Copyright Registration

APPLICATION FOR COPYRIGHT REGISTRATION

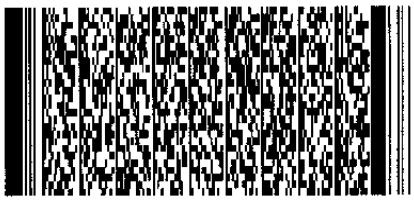
*** Designates Required Fields**

1 WORK BEING REGISTERED


ApplicationForCopyrightRegistration

1a. * Type of work being registered (*Fill in one only*)

- ☐ Literary work
- ☐ Performing arts work
- ☐ Visual arts work
- ☐ Motion picture/audiovisual work
- ☐ Sound recording
- ☐ Single serial issue


WorkTitles

1b. * Title of this work (*one title per space*)

1c. For a serial issue: Volume ☐ Number ☐ Issue ☐ ISSN ☐

Frequency of publication: ☐

1d. Previous or alternative title

☐

1e. * Year of completion ☐

Publication (*If this work has not been published, skip to section 2*)

1f. Date of publication ☐ (*mm/dd/yyyy*) **1g.** ISBN ☐

1h. Nation of publication ☐ United States ☐ Other

1i. Published as a contribution in a larger work entitled

☐

1j. If line 1i above names a serial issue Volume ☐ Number ☐ Issue ☐

Privacy Act Notice

Sections 408-410 of title 17 of the *United States Code* authorize the Copyright Office to collect the personally identifying information requested on this form in order to process the application for copyright registration. By providing this information you are agreeing to routine uses of the information that include publication to give legal notice of your copyright claim as required by 17 U.S.C. § 705. It will appear in the Office's online catalog. If you do not provide the information requested, registration may be refused or delayed, and you may not be entitled to certain relief, remedies, and benefits under the copyright law

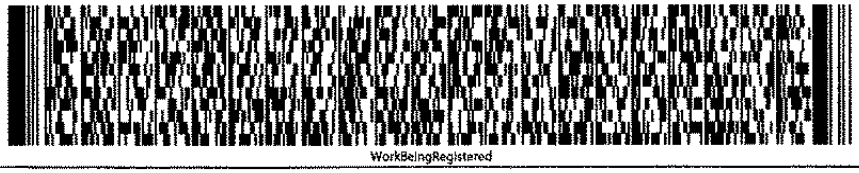
Print

UNITED STATES COPYRIGHT OFFICE

Form CO · Application for Copyright Registration

1k. If work was preregistered Number PRE- | | | | | | | | | | |

For Office Use Only



2 AUTHOR INFORMATION

2a. Personal name **complete either 2a or 2b*

First Name	Middle	Last

2b. Organization name

2c. Doing business as

2d. Year of birth **2e.** Year of death

2f. * ☐ Citizenship ☐ United States ☐ Other
☐ Domicile ☐ United States ☐ Other

2g. Author's contribution: ☐ Made for hire ☐ Anonymous ☐ Pseudonymous

Continuation of Author Information

2h. * This author created *(Fill in only the authorship that applies to this author)*

☐ Text	☐ Compilation	☐ Map/technical drawing	☐ Music
☐ Poetry	☐ Sculpture	☐ Architectural work	☐ Lyrics
☐ Computer program	☐ Jewelry design	☐ Photography	☐ Motion picture/audiovisual
☐ Editing	☐ 2-dimensional artwork	☐ Script/play/screenplay	☐ Sound recording/performance

Other:

For Office Use Only



Privacy Act Notice
Sections 408-410 of title 17 of the *United States Code* authorize the Copyright Office to collect the personally identifying information requested on this form in order to process the application for copyright registration. By providing this information you are agreeing to routine uses of the information that include publication to give legal notice of your copyright claim as required by 17 U.S.C. § 705. It will appear in the Office's online catalog. If you do not provide the information requested, registration may be refused or delayed, and you may not be entitled to certain relief, remedies, and benefits under the copyright law.

Print

UNITED STATES COPYRIGHT OFFICE

Form CO · Application for Copyright Registration

3 COPYRIGHT CLAIMANT INFORMATION

Claimant * ***complete either 3a or 3b*** - If you do not know the address for a claimant, enter "not known" in the Street address and City fields. You must give the address for at least one claimant.

3a. Personal name

First Name | Middle | Last

3b. Organization name

3c. Doing business as

3d. Street address *

Street address (line 2)

City * | State | ZIP / Postal code | Country

Email | Phone number

3e. If claimant is **not** an author, copyright ownership acquired by: ☐ Written agreement ☐ Will or inheritance ☐ Other

For Office Use Only

CopyrightClaimantInformation

Privacy Act Notice
Sections 408-410 of title 17 of the *United States Code* authorize the Copyright Office to collect the personally identifying information requested on this form in order to process the application for copyright registration. By providing this information you are agreeing to routine uses of the information that include publication to give legal notice of your copyright claim as required by 17 U.S.C. § 705. It will appear in the Office's online catalog. If you do not provide the information requested, registration may be refused or delayed, and you may not be entitled to certain relief, remedies, and benefits under the copyright law.

Print

UNITED STATES COPYRIGHT OFFICE

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4 LIMITATION OF COPYRIGHT CLAIM

Skip section 4 if this work is all new.

4a. Material excluded from this claim *(Material previously registered, previously published, or not owned by this claimant)*

☐ Text ☐ Artwork ☐ Music ☐ Sound recording/performance ☐ Motion picture/audiovisual

Other:

4b. Previous registration(s) Number Year

Number Year

4c. New material included in this claim *(This work contains new, additional, or revised material)*

☐ Text	☐ Compilation	☐ Map/technical drawing	☐ Music
☐ Poetry	☐ Sculpture	☐ Architectural work	☐ Lyrics
☐ Computer program	☐ Jewelry design	☐ Photography	☐ Motion picture/audiovisual
☐ Editing	☐ 2-dimensional artwork	☐ Script/play/screenplay	☐ Sound recording/performance

Other:

For Office Use Only

LimitationOfCopyrightClaim

Privacy Act Notice
Sections 408-410 of title 17 of the *United States Code* authorize the Copyright Office to collect the personally identifying information requested on this form in order to process the application for copyright registration. By providing this information you are agreeing to routine uses of the information that include publication to give legal notice of your copyright claim as required by 17 U.S.C. § 705. It will appear in the Office's online catalog. If you do not provide the information requested, registration may be refused or delayed, and you may not be entitled to certain relief, remedies, and benefits under the copyright law.

Print

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5 RIGHTS AND PERMISSIONS CONTACT

☐ Check if information below should be copied from the **first** copyright claimant

First Name | Middle | Last

Name of organization

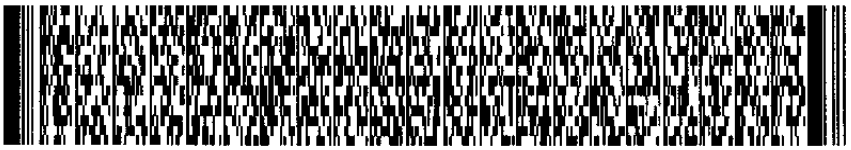
Street address

Street address (line 2)

City | State | ZIP / Postal code | Country

Email | Phone number

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6 CORRESPONDENCE CONTACT

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First name* | Middle | Last*

Name of organization

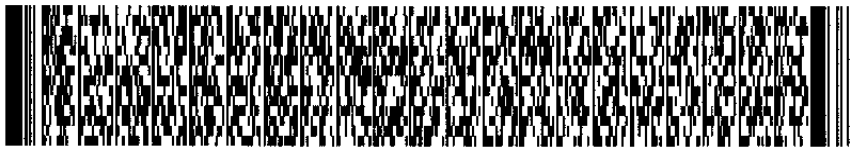
Street address*

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7a. First Name	Middle	Last

7b. Name of organization

7c. Street address *

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8 CERTIFICATION

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Sign Here

8a. Handwritten signature

8b. Printed name

12/16/2008

8c. Date signed

8d. Deposit account number

Account holder

8e. Applicant's internal tracking number (optional)

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Certification

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§8.36 VIII. MODEL CLOSING CHECKLIST

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

8.36-1 Model closing checklist, asset purchase and sale transaction

TargetCo, Inc.
Asset Sale

Signing and Closing Checklist
Asset Purchase Agreement, dated May 1, 2010

Legend

A	Acquiror: BuyerCo, Inc., a California corporation
P	ParentCo, Inc., a California corporation and parent of A
S	Seller: TargetCo, Inc., a California corporation
AC	Advisors to Corporations LLP, counsel to A
SC	Systematic Counselors LLP, counsel to S
TA	Terrific Accountants LLP, advisors to A
APA	Asset Purchase Agreement dated May 1, 2010, between A and S

References to sections, exhibits, and schedules in this checklist are to the APA unless noted otherwise.

Part I. Signing and Closing Documents and Deliverables

Item	APA Ref.	Document (and Signatories) or Action	Resp. Party	Status To-Do/ Done	Doc. No.
0 1	n/a	ASSET PURCHASE AGREEMENT (and all schedules and exhibits): A officer S officer SCHEDULES: Schedule 5.2 List of Excluded Domain Names Schedule 5.3 List of Excluded Trademarks	A / AC S / SC		1001

		Schedule 11.4 Employees Executing Offer Letters as of the Closing Date EXHIBITS: Exhibit A: Pro Rata Calculation Spreadsheet Exhibit B: Form of Parachute Payment Waiver Exhibit C: Form of Opinion of Seller's Counsel Exhibit D: Form of Patent Assignment Exhibit E: Form of Bill of Sale and Assignment and Assumption Agreement Exhibit F: List of Signatories to Release Agreement Exhibit G: Form of Escrow Agreement			
02	Art. II	S Disclosure Letter: S officer	S / SC		
03	n/a	A Board consent: A officer	A / AC		
04	n/a	S Board consent: S officer	A / AC		
05	n/a	S shareholder consent: SC	A / AC		
06	n/a	Wire instructions for S's bank: *[Bank contact]*	S		
07	n/a	Copies of executed Employee Agreements for employees listed in 2.3(g)	S		
08	2.4(g)	Consulting Agreements signed by key employees listed in 2.4(g) and officer of A, together with corresponding Proprietary Information and Inventions Agreements, Arbitration	A / AC		

		Agreements, and Conflicts of Interest Agreements: Employee 1 Employee 2 A			
0 9	2.5(g)	Offer letters signed by the continuing employees listed in 2.5(g), together with a Proprietary Information and Inventions Agreement, Arbitration Agreement, and Conflicts of Interest Agreement: Employee 1 Employee 2 Employee 3	A / AC		
0 10		License Agreement: Licensor 1 Licensor 2	A / AC S / SC		
0 11	2.7(c)	Termination agreements with transferred employees: Terminated Employee 1 Terminated Employee 2 Terminated Employee 3	S		
0 12	2.8(f)	Parachute Payment Waivers	A / AC S / SC		
0 13	2.12	IRC §280G information statement	S		
0 14	2.13	IRC §280G shareholder approval: S shareholder	S		
0 15	14.2	Legal opinion from S's counsel: SC	A / SC		
0 16	8.2(b)	Patent assignment signed by S: S	A / SC S / SC		
0 17	4.6(a)	Officer's certificate certifying S's (A) articles of incorporation, (B) bylaws, (C) board resolutions approving the principal terms of the APA and the asset purchase, (D) shareholder resolutions approving the principal terms of the APA and the asset purchase, and (E) no encumbrances on purchased assets. CFO of S	S / SC		

0 18	4.6(a)	Good standing certificates CA SOS CA FTB	S / SC		
0 19	4.6(a)	Bill of Sale and Assignment and Assumption Agreement. A S	A / AC S / SC		
0 20	7.1(a)	Vendor A Licensing Agreement. A S Nondisclosure Agreement A S	A / AC S / SC		
0 21	11.1(d)	Release Agreements executed by founders, investors, and employees or former employees: Founder A Investor 1 Employee 1	A /AC S / SC		
0 22	8.1(n)	Executed payoff and lien release letters: Releasor 1	S / SC		
0 23	8.4	Developed and tested prototype	S		
0 24	13.1	Vendor Escrow Agreement: A S Escrow Agent	A / AC S / SC		
0 25		Delivery of IP assets in electronic form	S		
0 26		Delivery in person of all books, records, documents, computer stored data, diskettes, files, and papers of Seller, whether in hard copy or computer format, relating to or used in connection with the Purchased Assets, including engineering information, specifications, documentation, technical or engineers' notes and logs, manuals, files, instructions, architecture designs, designs, listings, flowcharts, plans, drawings, diagrams, testing and test case databases, lists of present and former	S		

		suppliers, personnel and employment records (to the extent permitted by applicable law) relating to the Transferred Employees, and any information relating to Taxes imposed on the Purchased Assets			

Part II. Postclosing Documents and Actions; Miscellaneous

Item	APA Ref.	Document (and Signatories) or Action	Resp. Party	Status: To-Do/ Done	Doc. No.:
0 1	7.3	Executed UCC-2 and/or UCC-3 financing statements for all financing statements previously filed and outstanding with respect to the Purchased Assets	S		
0 2		Provide snapshot to Escrow Agent within 7 days after Closing	S		
0 3	15.2	Within 14 days after Closing, S must provide A with the name, mailing address, and date of termination of each COBRA "M&A qualified beneficiary"	S		
0 4	2.12	Purchase price allocation in accordance with IRC §1060: A officer	A		
0 5	212	A's IRS Form 8594 A officer	A		
0 6	2.12	S's IRS Form 8594 S officer	S		
0 7	13.5	S must provide A and C with unfettered access to the Enterprise Archive for 12 months after Closing	S	Continuous	
0 8	5.1(j)	If, after the Closing and before its liquidation, S makes any distribution to its shareholders, then S must retain sufficient cash to satisfy all obligations and liabilities and in no event shall have less than $_____ in cash immediately after any of such actions	S	Continuous	
0 9	5.1(k)	Seller must (i) continue to file all Tax Returns, and (ii) pay when due any and all Taxes attributable to or levied or imposed on the Purchased Assets for periods through and including the Closing Date whether or not such payment is required to be paid after the Closing Date	S	Continuous	
0 10	6.7	S shall not solicit A employees or customers for a period of 2 years after Closing	S	Continuous	
0 11	6.7	S shall notify A of any New Litigation Claim for a period	S	Continuous	

		through S's liquidation or the 1-year anniversary of the Closing (whichever comes earlier)			
0 12	2.6(c)	Holdback Release 50% 120 days after Closing; 75% one year after Closing	A		

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9

Intellectual Property in Secured Lending Transactions

Roxanne E. Christ

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I. INTRODUCTION

§9.1 A. Scope of Chapter

A security interest is an encumbrance against the assets of a grantor—usually a borrower or guarantor—that allows the secured party—usually a lender—to take possession of and resell the assets if the borrower defaults on its obligations to the secured party—usually by failing to repay the loan. A security interest can be created without being perfected, but a security interest that is not perfected can be trumped by third parties and is worthless if the borrower files bankruptcy. As a business matter, a lender's ability to obtain a perfected security interest will enable the borrower to obtain a loan that otherwise would not be available at all or would be available only at a higher interest cost.

This chapter explains how a lender can take and perfect a security interest in a borrower's intellectual property and related assets and how, after a borrower's default, the lender can exercise remedies with respect to its security interest. This chapter also addresses some of the practical challenges a lender faces when entering into a secured lending transaction when the collateral consists of intellectual property, such as how to monitor the collateral and ensure that it remains up-to-date.

The explanations are based on California law and, if preempted by federal law, applicable federal law as interpreted by California state courts and federal courts within the Ninth Circuit. Most secured transactions in personal property, including intellectual property, are governed by Division 9 of the California Commercial Code, which corresponds to Article 9 of the Uniform Commercial Code (UCC). The scope of Division 9 in California is set forth in Com C §9109. In this chapter, Uniform Commercial Code citations are distinguished from citations to the California Commercial Code by the inclusion of a hyphen (*e.g.,* UCC §9-306 versus Com C §9306), the phrase "UCC Article 9" refers generally to Article 9 of the UCC (including UCC Article 9 as enacted in California), and the phrase "Division 9" refers specifically to UCC Article 9 as it has been enacted in California. As discussed in this chapter, security interests in certain types of intellectual property are also subject to federal law. This chapter does not address security interests in intellectual property not subject to U.S. federal or state law.

For simplicity, this chapter refers to the secured party as the "lender" or "secured lender" and the debtor as the "borrower." In practice, the secured party may be someone other than an actual lender, such as a party who has obtained a security interest as collateral to guarantee performance of an obligation other than repayment of a loan. Likewise, a debtor may be someone other than a borrower who undertakes an obligation, such as a guarantor.

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§9.2 B. Treatment of Accounts and Royalty Streams

The transactions involving intellectual property security interests covered in this chapter are commercial loans with the repayment obligation secured by intellectual property. It should be noted that the sale of an account or chattel paper (*e.g.,* in a factoring transaction) is an entirely different type of transaction, but one to which UCC Article 9 also applies. The drafters of UCC Article 9 included sales of accounts in its coverage to piggyback on the mechanisms by which UCC Article 9 gives public notice of certain types of transactions involving intangible property (*e.g.,* sales of accounts receivable) that would otherwise give rise to secret or difficult-to-discover liens. UCC Article 9 achieves this by a logical fiction: It simply deems accounts to be security interests covered by UCC Article 9, with the buyer of the accounts as the secured party and the seller of the accounts as the debtor.

The fact that UCC Article 9 treats sales of accounts as security interests is important because the definition of account encompasses the royalty stream from an outbound intellectual property license. See §9.15. Although the intellectual property license itself is classified as a "general intangible" (see Com C §9102(a)(42)), the income stream (*e.g.,* royalties or other licensing fees) generated by an outbound intellectual property license is classified as an "account" under Com C §9102(a)(2). Accordingly, a lender seeking to take a security interest in a royalty stream must consider the prospect that the borrower might have sold, or in the future may attempt to sell, the same account. The lender should take steps to ensure that its security interest in the account will prevail over the rights of a purchaser of the same account. See §9.41.

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II. TYPES OF INTELLECTUAL PROPERTY COLLATERAL

§9.3 A. Defined Terms Used in This Chapter

Patents, copyrights, trademarks, and trade secrets are valuable forms of intellectual property commonly used as collateral in secured lending transactions. Domain names are not strictly intellectual property, but they are a form of intangible property that shares many features with trademarks, and they have become valuable assets that can serve as loan collateral. For convenience, all of these intangible assets are referred to in this chapter as "Pure IP Assets." Each of these Pure IP Assets can be subdivided into smaller sets of rights limited by characteristics such as duration, territory, scope of rights, or similar attributes. For example, a copyrighted work can be subdivided, with one person owning the right to reproduce, distribute, and modify the copyrighted work in print and another person owning the right to reproduce, distribute, and modify the work on television and in motion pictures. These subdivided rights can also serve as collateral. For convenience, these subdivided rights are referred to as "IP Rights."

A license or sublicense under which the borrower is the licensee or sublicensee and is granted the right to exploit IP Rights is yet another form of intellectual property that can be used as collateral. For convenience, these licenses and sublicenses are called "Inbound Licenses" and the rights under Inbound Licenses are referred to as "Licensed IP Rights." A license or sublicense under which the borrower is the licensor or sublicensor who grants to another party the right to exploit the borrower's Pure IP Assets or Licensed IP Rights is referred to in this chapter as an "Outbound License." Outbound Licenses can be used as collateral mainly because they generate upfront fees, ongoing royalties, or other forms of revenue payable to the borrower. The revenue they generate is called "IP Licensing Revenue."

For convenience, the types of collateral described above are collectively referred to as "IP Collateral." The procedures for creating, perfecting, and taking advantage of the different types of intellectual property collateral vary, depending on which type is at issue. Therefore, counsel to a lender taking (or a borrower granting) a security interest in any IP Collateral must be able to identify and distinguish among the different types.

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§9.4 B. Patents

Patents arise solely under federal statute. A patent is a grant, issued by the United States Patent and Trademark Office (PTO), of an exclusive right under the Patent Act of 1952 (35 USC §§1-376) to make, use, or sell an invention for a specified period of time, usually 20 years. A patent can be obtained for a device or process that is novel, useful, and nonobvious.

It can take months or even years for a patent to be issued after an application is filed. The application can be filed only by the actual inventor or inventors of the invention covered. If the PTO examiner determines that a patent is not warranted based on the application and accompanying materials, a patent may never be issued. Moreover, the fact that a patent has been issued does not necessarily mean that the patent is valid. Third parties can challenge the validity of a patent, and often do so if sued for patent infringement.

PRACTICE TIP: Most commercial lending lawyers are unable or unwilling to perform due diligence on the validity of an issued patent or to opine whether a patent will be issued from a particular application. The borrower's lawyer will often refuse to render an opinion concerning patent validity, and the borrower may be reluctant to share any validity analysis it might have received from patent counsel for fear of waiving the attorney-client privilege. The security agreement will usually contain a representation by the borrower that its patents are valid, but few well-advised borrowers will make this representation without a knowledge qualifier. Fewer still will represent and warrant that the borrower's patent applications will result in issued patents. Therefore, a lender who is relying on royalties from a certain patent for repayment of its loan or as the principal value of its collateral should consider hiring special patent counsel to analyze the validity of the patent (or the strength of the patent application). If the value of the collateral lies principally in a patent that has been applied for but has not yet issued, the lender should consider waiting until the patent issues before making the loan or else factoring the risk of non-issuance into the terms of the loan.

Patent rights can be divided in a myriad of ways for purposes of granting licenses, assigning interests, or using patent rights as collateral in secured lending transactions. For example, a patent holder might assign to Company A the exclusive right to make, use, and sell products that embody the patented technology for sale in North America, while granting other parties the same rights in other parts of the world. Alternatively or in addition, a patent holder might assign to Company A the exclusive right to make, use, and sell products for sale to a particular category of purchasers while reserving other classes of purchasers for itself. For example, the owners of a patent that covers a medical device might license the patent to a third party to market products covered by the patent to hospitals, while the patent holder retains the right to market covered products to individual doctors' offices. Similarly, the owner of a right to sell clothing bearing a famous trademark might license someone to sell products bearing the mark to specialty stores, while the owner retains the right to sell products to mass marketers or "big box" stores such as Best Buy or Wal-Mart.

NOTE: It is important to ascertain whether the rights held by the borrower constitute an ownership interest in the patent itself or are merely a license. The difference is important because, among other things, it determines what risk the lender would face if the borrower were to file bankruptcy. See chap 12.

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C. Copyrights and Mask Works

§9.5 1. Original Works of Authorship

A copyright is an original work of authorship arising under federal statute or, in the unusual case of pre-1972 sound recordings, state common law. The Copyright Act of 1976 (17 USC §§101-1332) protects an original work of authorship fixed in a tangible medium of expression from which it can be perceived. 17 USC §102(a). The owner of a copyright holds a bundle of exclusive rights, including the rights to reproduce, distribute, make derivative works from, and, if applicable (*e.g.,* as with motion pictures), publicly perform and publicly display the copyrighted work. See 17 USC §106. Like patent rights, the bundle of rights that flow from a copyright can be subdivided in numerous ways for purposes of granting licenses (either exclusive or nonexclusive), making outright assignments, or granting security interests.

Works of authorship created on or after January 1, 1978, do not need a formal copyright notice nor do they need to be registered, to be protected by copyright law. If the work is original and fixed in a tangible medium of expression from which it can be perceived, the work is automatically protected by copyright. See 17 USC §§102(a), 301, 401(a), 408(a). A copyright must be registered, however, in order to bring a civil action for copyright infringement, and there are certain other advantages to registration. See 17 USC §§411(a), 412.

NOTE: Although works of authorship created on or after January 1, 1978, do not need to be registered to enjoy copyright protection, the legal requirements for perfecting security interests in copyrighted works and transferring copyrights are very different depending on whether or not the work is registered. It is therefore essential for a lender taking a security interest in copyright collateral to determine whether the copyrights are registered and to consider whether to require the borrower to register any unregistered copyrights as a condition of the loan.

How long federal copyright protection lasts depends on many factors, such as when the work of authorship in question was created, when it was first published, whether it was created as a "work made for hire," and whether it was the creation of two or more joint authors. See generally 17 USC §§302-303. In most cases, copyrights in works created on or after January 1, 1978, subsist for the life of the author plus 70 years, *i.e.,* a very long time. See 17 USC §302. Even for works created before January 1, 1978 (see 17 USC §303), the duration of copyrights is long enough so that it is rarely an issue in a lender's collateral valuation. A more relevant issue is whether any copyrights to be included in the collateral were the subject of an earlier assignment or license that can be terminated during the life of the loan.

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§9.6 2. Termination Rights

Certain transfers or licenses of pre-January 1, 1978, copyrights are subject to termination under certain conditions by designated persons in accordance with 17 USC §304(c). Termination rights were created to give authors and their heirs an opportunity to recapture rights transferred to third parties, in view of the difficulty of predicting the future value of a creative work and the fact that the duration of copyright protection has been extended several times under federal law.

Termination rights have begun to vest under the Copyright Act in greater numbers, and are therefore not addressed in many loan documents. One of the first cases to address the issue was *Steinbeck v McIntosh & Otis, Inc.* (SD NY 2006) 433 F Supp 2d 395, which was reversed by the Second Circuit in *Penguin Group (USA) Inc. v Steinbeck* (2d Cir 2008) 537 F3d 193. A discussion of how copyright termination rights operate is beyond the scope of this chapter, but termination rights must be thoroughly analyzed in secured transactions involving older music publishing catalogues, movie libraries, literary publishing rights, and other content that derives its value from copyright protection. Termination rights will continue to ripen in greater numbers as the copyrights covered continue to age.

PRACTICE TIP: In secured lending transactions involving entertainment companies, it is essential for lender's counsel to cover termination rights in their due diligence, to obtain representations and warranties by the borrower describing any notices of termination that it has received or could receive during the life of the loan, to include provisions making the receipt of such notices an event of default if appropriate, and to include covenants that the borrower will furnish copies of any termination notices to the lender on receipt.

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§9.7 3. Mask Works

The Semiconductor Chip Protection Act of 1984 (17 USC §§901-914), part of the Copyright Act, protects the topography of semiconductor chips, also known as mask works, even though chip surfaces are purely functional in nature. See 17 USC §§901-914. Unlike copyrights, mask works must be registered to be protected under the Copyright Act, and a mask work must be registered within 2 years after the date on which it is first commercially exploited. 17 USC §908(a).

The owners of a registered mask work have the exclusive right to reproduce the mask work by optical, electronic, or any other means, and to import or distribute a semiconductor chip product in which the mask work is embodied. 17 USC §905. Protection for a mask work begins on the date that the mask work is registered with the Copyright Office, or the date when the mask work is first commercially exploited anywhere in the world, whichever occurs first, and lasts for only 10 years. 17 USC §904(a).

Like the owner of a copyright in an original work of authorship, the owner of a mask work may transfer any or all of its rights by a writing signed by the owner or its duly authorized agent. The exclusive rights in a mask work may also be transferred by operation of law, terms of a will, or intestate succession. 17 USC §903(b). As in the case of a work of authorship, any document pertaining to a mask work may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document. The recordation of any transfer or license is intended to give all persons constructive notice of the facts stated in the recorded document concerning the transfer or license. 17 USC §903(c)(1).

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D. Trademarks and Domain Names

§9.8 1. Trademarks

A trademark (or service mark) is a word, phrase, symbol, or design, or a combination of words, phrases, symbols, or designs, that identifies the source of a product (or service) and distinguishes it from products (or services) offered by others. A trademark is intended to prevent consumer confusion and derives much of its value from the goodwill associated with the goods and services with which it is identified. Trademark rights are fundamentally common law rights, acquired through usage in commerce. Unlike patents or copyrights, they are not created by federal law; however, they can be registered with the PTO under the federal trademark law (the Trademark Act of 1946, also known as the Lanham Act, 15 USC §§1051-1127) if they are used (or will be used) in interstate commerce. See 15 USC §1051. A mark can also be registered in states where it is used. In California, see Bus & P C §14200-14272. Both the registration and an application for registration can be valuable assets, but only insofar as they represent the trademark and goodwill of the business that they purport to identify.

Common law rights in a trademark, along with any federal or state registrations, can be used as loan collateral with two important caveats:

First, great care should be exercised in the case of an application for registration of a trademark that the applicant intends to use but has not yet used (a so-called "ITU" application). See 15 USC §1051(b). To discourage trafficking in trademarks, §10 of the Lanham Act prohibits assignment of an application to register a mark before a verified statement of use has been filed, except to a successor to the business of the applicant (or the portion of the business to which the mark relates). See 15 USC §1060(a). In *Clorox Co. v Chemical Bank* (TTAB 1996) 40 USPQ2d 1098, the Trademark Trial and Appeal Board (TTAB) ruled that an absolute assignment of an ITU taken by a lender with a license back to the borrower violated §10, and that the appropriate remedy was not merely invalidation of the lender's interest but also cancellation of the resulting trademark registration. In light of this, it is common for security agreements either to carve out ITUs before a verified statement of use has been filed or to carve them out to the extent that granting a security interest in an ITU would violate federal law. See §9.32.

Second, a trademark cannot be separated from the goodwill of the business it represents. The transfer of a trademark without its associated goodwill, called an "assignment in gross" or "naked transfer," is invalid and can invalidate the trademark itself, rendering it worthless as collateral. See *E.&J. Gallo Winery v Gallo Cattle Co.* (9th Cir 1992) 967 F2d 1280, 1289. See §9.32.

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§9.8A 2. Domain Names

A domain name serves two functions: (1) It identifies the address of a website on the Internet, and (2) it serves as a source identifier for goods, services, or information associated with it. It is comprised of two sequences of characters separated by a "dot" (*e.g.,* "redcross.org"). The element immediately to the left of the dot is called a second-level domain (SLD), which is generally a source identifier such as a company's name (*e.g.,* "redcross"). The element to the right of the dot is known as a top-level domain (TLD), which is an extension designation (*e.g.,* ".org"). The full address is known as a uniform resource locator (URL) (*e.g.,* "http://www.redcross.org"). See Patent and Trademark Office Examination Guide No. 2-99 (1999). The Internet Corporation for Assigned Names and Numbers (ICANN), a non-profit corporation, oversees the domain name registration process and provides a mechanism for centralized dispute resolution. However, the commercial business of distributing and granting ownership of domain names is performed by numerous competing domain name registrars that enter into contracts with registrants, granting them the exclusive use of a domain name on a first-come, first-served basis.

Trademarks and domain names share strong similarities and are often coupled together for collateral purposes, but an important distinction exists between the two. Both are often comprised of a word or phrase used to identify the source of products or services. In addition, both derive most of their value from the goodwill associated with a company's products or services. These common features enable a domain name owner to attain federal trademark rights in a domain name, subject to the same requirements for all other applicants seeking federal trademark protection. See Patent and Trademark Office Examination Guide No. 2-99 (1999). It is often the case that a domain name is composed of a company's name protected by a trademark (*e.g.,* http://www.mcdonalds.com). In addition, standard trademark definitions contained in security agreements often include domain names. See §9.29. Accordingly, a domain name that qualifies as a trademark can reap many, if not all, the benefits and protections afforded by trademark ownership, including the ability to grant a security interest in the domain name for secured lending purposes. However, unlike trademarks, which can be registered with the PTO or in the state where they are used, a domain name is registered with a private registrar. Consequently a domain name and all of its accompanying rights and limitations originate from a private contract between the registrar and the registrant.

NOTE: This key distinction between domain names and trademarks has led to two different legal interpretations of a domain name. Some courts view domain names as service contracts divorced from independent intellectual property rights. See *Network Solutions Inc. v Unmbro Int'l Inc.* (Va 2000) 529 SE2d 80, 86 (domain names cannot be garnished because they are merely contracts for services; they are not property rights, but lenders do have a "property" interest in the form of the value of the contract right). Other courts, including the Ninth Circuit, view domain names as intangible property rights held by the registrant. See *Kremen v Cohen* (9th Cir 2003) 337 F3d 1024, 1030 (holding that a domain name is a property interest because (1) it is an interest capable of precise definition, (2) it is capable of exclusive possession or control, and (3) the owner of a domain name has established a legitimate claim to exclusivity).

NOTE: Another category of intangible Internet property similar to a trademark is a social network or virtual world account, such as accounts on Facebook, Second Life, and Twitter. These accounts can be valuable branding and customer relations channels for a borrower, and should be included as collateral.

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§9.9 E. Trade Secrets

Trade secret rights arise under common law and state statutes. There is no federal law governing trade secrets as such. Like most states, California has adopted the Uniform Trade Secrets Act (CC §§3426-3426.11), which defines a trade secret as follows (CC §3426.1(d)):

> [I]nformation, including a formula, pattern, compilation, program, device, method, technique, or process, that
> (1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and
> (2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

There are a number of issues relating to the use of trade secrets as loan collateral, which are discussed in §§9.10-9.12.

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§9.10 1. Practical Problems in Relying on Trade Secrets as Collateral

A borrower's trade secrets may be among its most valuable assets. Patent applications that have not been made public often embody trade secrets. Even for a company with technologies covered by issued patents, trade secrets are often essential to knowing *how* to put patented technologies to actual use. The intellectual property in software usually consists of both copyrighted works and trade secrets. Given the importance of trade secrets in many types of businesses, a company's trade secrets should always be included in the collateral package when a lender makes an asset-based loan. As discussed in §§9.11-9.12, however, it can be impractical if not impossible for a lender to place meaningful value on trade secrets as collateral.

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§9.11 2. Problem of Describing Trade Secrets Too Carefully

The main problem for a lender relying on trade secrets as loan collateral is that the borrower will be justifiably reluctant to describe its trade secrets with any useful level of specificity in the security agreement, for fear that the description could find its way into a competitor's hands. If the trade secrets are not described in sufficient detail, however, the lender will have difficulty monitoring, and may even have difficulty proving that it holds, a security interest in the borrower's trade secrets.

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§9.12 3. Problem of Accessing Trade Secrets in Event of Default

Even if a lender manages to obtain and perfect a security interest in the borrower's trade secrets, the lender could have difficulty foreclosing on the collateral if the borrower defaults. For example, if the trade secrets are known only to the borrower's senior executives, the lender may have difficulty getting access to the trade secrets so that it can foreclose. A lender who tries to foreclose on trade secrets might not be able to protect them against misappropriation, because a plaintiff who seeks relief for misappropriation of trade secrets must identify them and carry the burden of showing that they exist. *MAI Sys. Corp*. (9th Cir 1993) 991 F2d 511, 522, cert dismissed sub nom *Peak Computer v MAI Sys. Corp*. (1994) 510 US 1033. It is insufficient for a plaintiff to state, for example, that its software "contain[s] valuable trade secrets." 991 F2d at 522.

PRACTICE TIP: In a secured loan transaction where the borrower's trade secrets can be reduced to writing and are crucial to the borrower's continued ability to service the loan (*e.g.,* if the borrower manufactures and sells food products based on proprietary recipes or ingredients), the lender should consider requiring that a record of the trade secrets be placed into escrow and delivered to the lender upon an event of default. The lender should require an officer of the borrower to certify that the materials placed in escrow provide a complete description of the trade secrets and should require the borrower to update the materials in escrow from time to time.

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§9.13 F. Combined and Overlapping Types of Intellectual Property

As a practical matter, IP Collateral often includes more than one type of intellectual property. For example, the intellectual property rights in the video game playable on a Microsoft Xbox 360, based on the movie "Scarface," includes (1) trademarks of the video game developer, the video game publisher, the movie's producer, and the distributor, among others; (2) Microsoft's patented technology that allows the game to interface with the Xbox 360 console; (3) copyrights in the game itself, its underlying software, and in the movie on which the game is based; and (4) the right to use the names, voices, and likenesses of the actors depicted in the game. Moreover, although the game's developer may own some of these intellectual property rights outright, many of them will be licensed from third parties.

When dealing with overlapping and combined intellectual property rights, lender's counsel and borrower's counsel must parse through each different right and ensure that their documents meet the requirements for creating, perfecting, and enforcing security interests in each of these rights. Unfortunately, many reported court cases involving intellectual property security interests fail to describe precisely what type of intellectual property is being analyzed.

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§9.14 G. Inbound Intellectual Property Licenses

In secured loans involving intellectual property, most IP Collateral will not be Pure IP Assets or even IP Rights. See §9.3. Instead, most IP Collateral consists of Inbound Licenses and their corresponding Licensed IP Rights, because Pure IP Assets and IP Rights can be licensed and sublicensed many times in many ways. Counsel must identify the *kinds* of IP Rights being licensed or sublicensed to the borrower, as well as the terms of the licenses themselves, to be sure that the loan documents give the lender a valid, perfected, and first-priority security interest in the Licensed IP Rights as well as the Inbound Licenses themselves.

NOTE: An exclusive copyright license is an exception to this principle. Although most intellectual property licenses are merely contract rights (classified as "general intangibles" under Com C §9102(a)(42)), the Copyright Act specifically states that an exclusive copyright license conveys to the licensee an interest in the underlying copyright itself. See 17 USC §§101, 201.

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§9.15 H. Outbound Intellectual Property Licenses

When the borrower is the licensor rather than the licensee of Pure IP Assets or IP Rights, the value of the license as collateral will consist of the borrower-licensor's right to collect royalties or other licensing fees from the licensee and to sue the licensee for breach of contract if the licensee fails to pay the amounts due under the license.

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§9.16 I. Intellectual Property Litigation Claims

When a borrower owns Pure IP Assets or IP Rights, there may be collateral value in the borrower's right to bring infringement or misappropriation claims against third parties.

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§9.17 J. Proceeds

What happens to the secured creditor's security interest in intellectual property collateral if (with or without the consent of the secured creditor) the debtor sells, licenses, or disposes of its interest in the intellectual property? Under UCC Article 9, once a security interest in collateral attaches, it travels with the collateral if the collateral is sold, exchanged, licensed, or disposed of *without* the secured party's consent. Specifically, Com C §9315(a)(1) states: "A security interest… continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest." If the secured party authorized the disposition, then the security interest in the collateral is extinguished. It appears that the secured party's authorization need not be express; it can be implied. See Ward, Intellectual Property in Commerce §2:28 n4 (West Group 2009), citing UCC §9-315(a)(1), UCC §9-306 Official Comment 3, and PEB Commentary No. 3 (March 10, 1990) ("Comment 2 to Revised Section 9-315 makes clear that implied authorization for a disposition of collateral is still an important protection for buyers").

Whether or not the secured party's interest in the collateral continues in the collateral itself, it attaches to the proceeds of the collateral. This is because Com C §9315(a)(2) states, "A security interest attaches to any identifiable proceeds of collateral." Commercial Code §9102(a)(64) defines "proceeds" to include:

- "Whatever is acquired upon the sale, license, exchange, or other disposition of collateral";
- Whatever is collected on, or distributed on account of, collateral;
- Rights arising out of collateral; and
- To the extent of the value of collateral, claims arising out of infringement of rights in collateral.

If the proceeds are cash, the cash must be "identifiable" to be considered proceeds. See Com C §9315(a)(2). If the cash is commingled, the UCC defers to state law for permissible methods of tracing, including application of equitable principles. See Com C §9315(b)(2). Noncash proceeds will generally become unperfected on the 21st day after attachment unless the requirements of Com C §9315(d) are satisfied.

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§9.18 K. Related Intangible Property Assets: Publicity Rights

Publicity rights are another form of intangible property that are not strictly intellectual property but, like domain names, have some of the same features as intellectual property and can also serve as loan collateral. In California, publicity rights protect an individual against the unauthorized use of his or her "name, voice, signature, photograph, or likeness," particularly in connection with commercial speech. CC §3344(a). Furthermore, publicity rights are descendible under CC §990, may continue to have commercial value even after an individual's death, and are protected for 50 years after the individual's death. CC §990(g). Section 990 further clarifies that publicity rights are property rights that are "freely transferable, in whole or in part." CC §990(b). As such, publicity rights, like other intangible property rights, can be used as loan collateral, and, given the commercial value inherent in a celebrity's name, voice, signature, photograph, or likeness, can be one of the most important types of related intangible property rights.

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III. CREATING INTELLECTUAL PROPERTY SECURITY INTERESTS

§9.19 A. What Law Governs?

UCC Article 9 governs the creation of security interests in all IP Collateral. Arguably, however, for both registered and unregistered copyrights, the Copyright Act also governs, or perhaps even preempts UCC Article 9 (see Com C §9109(c)(1)), because the Copyright Act defines a "transfer of copyright ownership" as "an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license." 17 USC §101. The Copyright Act requires that such transfers of copyright ownership be made "in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent." 17 USC §204. UCC security agreements are normally also made in writing and signed by the owner of the collateral (see §§9.23-9.24), and therefore normally comply with the Copyright Act requirements for transfer of copyrights.

The federal laws that govern patents and registered trademarks do not include the word "mortgage" or other language denoting security interests in their provisions dealing with transfers. See 15 USC §1060(a) (trademark assignments); 35 USC §261 (patent assignments). As a result, federal law should not govern the creation of security interests in patent or trademark collateral. See *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied (2002) 534 US 1130 (patents); *Roman Cleanser Co. v National Acceptance Co. (In re Roman Cleanser Co.)* (Bankr ED Mich 1984) 43 BR 940, aff'd (6th Cir 1986) 802 F2d 207 (trademarks).

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§9.20 B. UCC Article 9 Requirements

A security interest is an interest in personal property that secures repayment of a loan or performance of a borrower's other obligations under loan documents. See Com C §1201(a)(35). A security interest can be created, but does not "attach" to collateral (and thereby become enforceable against the borrower) unless the requirements of Com C §9203 are met. A security interest that has not attached cannot be perfected (see Com C §9308(a)), and if not perfected, it will not have priority over security interests held by third parties, nor over a trustee in bankruptcy if the borrower files bankruptcy.

A security interest attaches to collateral when it becomes enforceable, unless an agreement expressly postpones the time of attachment. Com C §9203(a). A security interest becomes enforceable when (Com C §9203(b)):

- Value has been given (usually by the secured party) (see §9.21);
- The borrower has rights in the collateral or the power to transfer rights in the collateral to a secured party (see §9.22); and
- When IP Collateral is involved, the borrower has authenticated a security agreement that evidences the borrower's intent to create a security interest in the collateral and describes the collateral (see §§9.23-9.25).

All three requirements must be met, but they need not be met in any particular order.

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§9.21 1. Value Given

Commercial Code §1204 defines "value" broadly to include not only a present loan, but also a present binding commitment to make a loan in the future. There is no requirement that the value given be equivalent to the value of the collateral.

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§9.22 2. "Rights in the Collateral"

UCC Article 9 does not define "rights in the collateral" for purposes of Com C §9203(b), but many commentators believe that the term has a broad meaning as applied to intellectual property. Equitable title that falls short of legal title may constitute enough "rights in the collateral" for a security interest to attach. For example, an oral assignment of a patent is ineffective to convey legal title, but is sufficient to convey equitable title to a patent that has issued or for which an application has been filed (see Ward, Intellectual Property in Commerce §2:24 (West Group 2009), citing 5 Lipscomb, Walker on Patents §§19:4, 19:28 (1986); *Gasser Chair Co., Inc. v Infanti Chair Mfg. Corp*. (ED NY 2006) 2006 US Dist Lexis 13402), and therefore should be sufficient for a security interest to attach to the patent. Likewise, a written promise to assign a patent in the future will convey equitable, though not legal, title to the patent. See Ward, Intellectual Property §2:24, n20, 23 (citing *Filmtec Corp. v Allied-Signal Inc*. (Fed Cir 1991) 939 F2d 1568 for this proposition). Nonetheless, the written promise should be enough "rights" for the secured party to have a security interest in the patent to attach. A debtor's rights in collateral need not be invulnerable in order to serve as collateral. Nonetheless, to the extent they are vulnerable, the secured party's interest in those rights will be vulnerable as well.

PRACTICE TIP: An assignment of a patent, patent application, trademark registration, or registered copyright that will be effective against subsequent transferees requires recording of a written instrument of assignment with the PTO (in the case of patents and trademarks) (see 15 USC §1060; 35 USC §261) or the Copyright Office (in the case of registered copyrights) (see 17 USC §205). A lender who is looking to such registered IP Collateral for value or royalties from which its loan will be repaid should require the recordation of any assignments at the PTO or Copyright Office as necessary to fill any gaps in the borrower's chain of title.

PRACTICE TIP: The security agreement will almost certainly contain a representation by the borrower that the borrower has good title to the intellectual property being pledged as collateral. If the representation is wrong, however, the lender has, at most, a breach of contract claim (or perhaps a fraud claim) and the right to declare an event of default. A borrower cannot grant a security interest that is broader than the rights the borrower owns or controls. A lender wishing to avoid the risk that its borrower's title could be trumped by an intervening transferee (without notice of an earlier, unrecorded assignment) should consider waiting at least 3 months for patents (see 15 USC §1060; 35 USC §261) or one month for registered copyrights (see 17 USC §205) from the date the borrower pledges the intellectual property as collateral before closing its lending transaction. In practice, however, few lenders do this.

Stated differently, a secured party's rights in IP Collateral are no broader than the rights that the borrower had in the IP Collateral to grant. Similarly, a third party cannot claim bona fide purchaser status unless the party in fact acquires legal title to the collateral in question. See *Rhone-Poulenc Agro, S.A. v DeKalb Genetics Corp.* (Fed Cir 2002) 284 F3d 1323, cert denied (2003) 539 US 957. The "protections of the bona fide purchaser rule extend only to those who have received an 'assignment, grant or conveyance,' " and the UCC does not override this common law principle. 284 F3d at 1333.

Accordingly, lender's counsel must perform a due diligence investigation to confirm that the borrower actually owns or controls (or has been authorized to transfer) the collateral that it is mortgaging. When the collateral is IP Collateral, this diligence can be expensive and time-consuming, because it often requires a search of the chain of title from the creation of the IP down to the borrower, coupled with a review of the borrower's records and operations to confirm that the borrower did not subsequently transfer any interest in the collateral.

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3. Authenticated Security Agreement That Describes the Collateral

§9.23 a. Authentication

The term "authenticate" is defined in Com C §9102(a)(7) to mean either "to sign" or "to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record." In general, for purposes of Com C §9203(b), the borrower must have the power to enter into the security agreement, and the agreement must have been duly authorized, signed, and delivered to the secured lender. See *Special Report of the TriBar Opinion Committee* §3.3(a), 58 Bus Law 1465 (Aug. 2003).

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§9.24 b. Security Agreement

In a somewhat circular fashion, Com C §9102(a)(73) defines a "security agreement" as "an agreement that creates or provides for a security interest." The agreement need not use the word "grant" but must evidence an intention by the debtor to create a security interest. Official Comment 3b to UCC §9-102. The term "security interest" is defined generally in Com C §1201(a)(35) as "an interest in personal property or fixtures which secures payment or performance of an obligation." An agreement that functions like a security agreement will therefore be treated as one, irrespective of its title.

As an example, for IP Collateral, a lender with negotiating leverage can sometimes persuade the borrower to execute a conditional intellectual property assignment. The assignment might take either the form of one effective only on the borrower's default or the form of one immediately effective with an assignment back to the borrower once the secured debt has been repaid in full. Under UCC Article 9, such agreements are treated as security agreements and, accordingly, the secured lender's rights and remedies under them are circumscribed by the UCC Article 9 borrower protections. See Com C §1201(a)(35). On the other hand, the PTO will disregard the conditions and treat the document as an outright assignment. A bankruptcy filing by the borrower, however, may operate to cut off the lender's interest, depending on how it is structured. See *In re Storm Technol., Inc.* (Bankr ND Cal 2001) 260 BR 152. Conditional assignments are discussed further in §§9.46-9.48.

When the collateral consists of Pure IP Assets that are registered or filed with the PTO or the Copyright Office (*i.e.,* patents, patent applications, registered copyrights, applications for copyright registrations, trademark registrations, and applications for trademark registrations), the lender and borrower will often have a separate "short form" security agreement covering only the intellectual property. This is usually done so that the shorter document, rather than the full security agreement, can be recorded with the PTO or Copyright Office to achieve perfection (in the case of registered copyrights) or to put bona fide purchasers of trademarks and patents on notice. Samples of such agreements are in App D-1-D-3. Rather than use an individual short form security agreement for each type of intellectual property, the parties will sometimes use a combined short form covering all intellectual property.

PRACTICE TIP: If the collateral includes IP Collateral that is particularly important to the borrower's business or valuable in its own right, and that is registered or filed with a government office, the better practice is to separate the IP Collateral by its type and record a security agreement for each type, rather than to combine them. By doing so, each agreement can be specifically tailored to the particular type of intellectual property covered.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.25 c. Description of Collateral

§9.25 c. Description of Collateral

A "sufficient" collateral description is one that "reasonably identifies what is described." Com C §9108(a)-(b). It is never sufficient for a security agreement to refer merely to "all of the debtor's property" or words to that effect. Com C §9108(c). Yet collateral descriptions in security agreements almost always refer to categories or types of collateral covered, rather than listing the borrower's assets item by item. The types of collateral described are based on definitions contained in UCC Article 9. The following types of collateral and their statutory definitions are the ones most relevant when IP Collateral is concerned:

TYPE OF COLLATERAL	**DEFINITION**
Account**:** Com C §9102(a)(2)	A right to payment of a monetary obligation, whether or not earned by performance, (i) For property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) For services rendered or to be rendered, The term does not include (i) Rights to payment evidenced by chattel paper or an instrument, (ii) Commercial tort claims, (iii) Deposit accounts.
Cash proceeds: Com C §9102(a)(9)	Money, checks, deposit accounts, or the like.
Chattel paper: Com C §9102(11)	A record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and licenses of software used in the goods, a lease of specific goods, or a lease of specific goods and licenses of software used in the goods, where "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods.
Commercial tort claim: Com C §9102(a)(13)	A claim arising in tort with respect to which (A) the claimant is an organization, or (B) the claimant is an individual and both (i) the claim arose in the course of the claimant's business or profession, and (ii) the claim does not include damages arising out of personal injury to or the death of an individual.
Consumer goods: Com C §9102(a)(23)	Goods that are used or bought for use primarily for personal, family, or household purposes.
Deposit account: Com C §9102(a)(29)	A demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument.
General intangibles: Com C §9102(a)(42)	Any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.
Goods: Com C §9102(a)(44)	All things that are movable when a security interest attaches. The term includes a computer program embedded in goods and any supporting information

	provided in connection with a transaction relating to the program if (i) The program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) By becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, or instruments.
Inventory: Com C §9102(a)(48)	Goods, other than farm products, which are any of the following: (A) Leased by a person as lessor. (B) Held by a person for sale or lease or to be furnished under a contract of service. (C) Furnished by a person under a contract of service. (D) Consist of raw materials, work in process, or materials used or consumed in a business.
Payment intangible: Com C §9102(a)(61)	A general intangible under which the account debtor's principal obligation is a monetary obligation.
Proceeds: Com C §9102(a)(64)	(A) Whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral. (B) Whatever is collected on, or distributed on account of, collateral. (C) Rights arising out of collateral. (D) To the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral. (E) To the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.
Promissory note: Com C §9102(a)(65)	An instrument that evidences a promise to pay a monetary obligation, does not evidence an order to pay, and does not contain an acknowledgment by a bank that the bank has received for deposit a sum of money or funds.
Software: Com C §9102(a)(75)	A computer program and any supporting information provided in connection with a transaction relating to the program. The term does not include a computer program that is included in the definition of goods.

In general, references to collateral types are sufficient to "reasonably identif*[y]* what is described." See Com C §9108(a). Some types of collateral, however, must be described with greater particularity. Intellectual property infringement claims and other commercial tort claims must be described more specifically. Com C §9108(e). The description should include the name of the alleged infringer and nature of the infringement, as well as the case name and number if available.

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C. Creation Requirements for Specific IP Collateral Types

§9.26 1. Pure IP Assets and IP Rights

From the lender's perspective, the principal challenge in applying UCC Article 9's requirements for creating a security interest to specific types of Pure IP Assets is to make sure that the definitions used in the security agreement are as comprehensive as possible and that the defined terms become part of the definition of the "Collateral." This will often lead to overlapping definitions, which can be troublesome for the borrower if they are incorporated in the borrower's representations and warranties. Hence, the borrower should push the lender to define the terms in such a way as to be precise and mutually exclusive. For example, the borrower may want patent licenses, patent infringement claims, and patent proceeds excluded from the definition of "patents" and addressed elsewhere. Alternatively, the borrower may propose narrower definitions to avoid circularity in its representations and warranties concerning the IP Collateral. Because not all "intellectual property" falls neatly into the general categories of patents, copyrights, trademarks, and trade secrets, the lender should consider including in the definition of Collateral a "catchall" intellectual property definition as well. Sample definitions are set forth in §§9.27-9.31, but each of these definitions can and should be tailored to the borrower's business.

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2. Sample Definitions of IP Collateral

§9.27 (a) Form: Sample Definition of "Patents"

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9.27-1 Sample definition of "patents"

"Patents" shall mean all national, foreign and multinational patents and certificates of invention, or similar industrial property rights, and applications for any of the foregoing, including, but not limited to: (i) each patent and patent application referred to in Schedule _ _ hereto (as such schedule may be amended or supplemented from time to time) and all rights therein provided by international treaties or conventions, (ii) all reissues, divisions, continuations, continuations-in-part, extensions, renewals, and reexaminations thereof, (iii) all inventions and improvements described therein, and (iv) all rights corresponding thereto throughout the world.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.28 (b) Form: Sample Definition of 'Copyrights'

§9.28 (b) Form: Sample Definition of "Copyrights"

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9.28-1 Sample definition of "copyrights"

"Copyrights" shall mean all registered and unregistered common law, state, national, foreign, and multinational copyrights (including Community designs), including but not limited to copyrights in software and databases, and all Mask Works (as defined under 17 USC §901 of the U.S. Copyright Act), and, with respect to any and all of the foregoing: (i) all registrations and applications therefor including, without limitation, the registrations and applications referred to in Schedule _ _ hereto (as such schedule may be amended or supplemented from time to time), (ii) all extensions and renewals thereof, (iii) all reversionary interests and termination rights, (iv) all rights to accounting, (v) all moral rights, including attribution and integrity, and (vi) all rights corresponding thereto throughout the world.

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§9.29 (c) Form: Sample Definition of "Trademarks"

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9.29-1 Sample definition of "trademarks"

"Trademarks" shall mean all registered and unregistered, common law, state, national, foreign, and multinational trademarks, trade names, corporate names, company names, business names, fictitious business names, Internet domain names, service marks, certification marks, collective marks, logos, other source or business identifiers, designs, and general intangibles of a like nature, all registrations and applications for any of the foregoing including, but not limited to: (i) all marks registered in the United States Patent and Trademark Office, the Trademark Offices of the States and Territories of the United States of America, and the Trademark Offices of other nations throughout the world, and all rights therein provided by international treaties or conventions, including the registrations and applications referred to in Schedule _ _ hereto (as such schedule may be amended or supplemented from time to time), (ii) all extensions or renewals of any of the foregoing, (iii) all of the goodwill of the business connected with the use of and symbolized by the foregoing, and (iv) all corresponding rights throughout the world.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.30 (d) Form: Sample Definition of 'Trade Secrets'

§9.30 (d) Form: Sample Definition of "Trade Secrets"

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9.30-1 Sample definition of "trade secrets"

"Trade Secrets" shall mean all national, foreign, and multinational trade secrets and all other confidential or proprietary information and know-how whether or not such information has been reduced to a writing or other tangible form, including (i) manufacturing and production processes and techniques, (ii) research and development information, (iii) drawings, specifications, designs, plans, proposals, technical data, financial, marketing, and business data, (iv) pricing and cost information, (v) business and marketing plans, (vi) customer and supplier lists and information, (vii) all rights to obtain and rights to apply for patents and contents of patent applications, and (viii) all rights corresponding thereto throughout the world.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.31 (e) Form: Sample Definition of 'Other Intellectual Property'

§9.31 (e) Form: Sample Definition of "Other Intellectual Property"

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9.31-1 Sample definition of "other intellectual property"

"Other Intellectual Property" shall mean all (i) inventions, whether or not patentable, whether or not reduced to practice, and whether or not yet made the subject of a pending patent application or applications, (ii) ideas and conceptions of potentially patentable subject matter, including, without limitation, any patent disclosures, whether or not reduced to practice and whether or not yet made the subject of a pending patent application or applications, (iii) databases, (iv) domain names, (v) rights to use the names, likenesses, voices, and biographical data of natural persons and publicity rights, and (vi) all corresponding rights thereto throughout the world.

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§9.32 3. Trademarks and Intent-to-Use Applications for Trademark Registrations

As noted in §9.8, a so-called intent-to-use (ITU) application can be filed to register a trademark that the applicant intends to use but has not yet used. See 15 USC §1051(b). However, a lender should not take a security interest in an ITU application from someone who is not a successor to the applicant's business unless and until a verified statement of actual use has been filed with the PTO relating to the application. See 15 USC §1060(a). The prohibition against assignment of ITU applications is intended to discourage trafficking in trademarks. Granting a security interest in an ITU application to someone who is not the successor to the applicant's business before the verified statement of actual use is filed could arguably invalidate the application and void any resulting registration. See *Clorox Co. v Chemical Bank* (TTAB 1996) 40 USPQ2d 1098.

Further, as noted in §9.8, a trademark cannot be separated from the goodwill of the business it represents. To the extent that a grant of a security interest in a trademark can be construed as a transfer of the trademark itself but without its associated goodwill, the grant can also be construed to be an "assignment in gross" or "naked transfer." Assignments in gross are not only invalid, but they can invalidate the trademark itself, rendering it worthless as collateral. See *E.&J. Gallo Winery v Gallo Cattle Co.* (9th Cir 1992) 967 F2d 1280, 1289.

NOTE: Avoiding an assignment in gross does not require that tangible assets be transferred along with the trademark. If no tangible assets are transferred, however, there must be a continuity of the product or service symbolized by the mark to avoid deceiving or confusing customers. If the goods or services offered under the trademark after its assignment are "substantially similar" to those associated with the mark prior to its assignment, then such continuity exists. See *Glow Indus., Inc. v Lopez* (CD Cal 2003) 273 F Supp 2d 1095. Nonetheless, in leveraged finance transactions that involve securitizations of trademark receivables, lenders and investors often require the borrower to assign its trademarks to a special purpose entity (SPE) in an effort to insulate the trademark receivables from the risk of bankruptcy of the borrower and prohibit the SPE from conducting any business operations, thereby making it impossible for the SPE to be generating or holding any goodwill of the business that the trademark represents. Curiously, such assignments do not appear to have been challenged as assignments in gross.

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§9.33 4. Inbound Intellectual Property Licenses and Licensed Rights: Contractual Restrictions on Assignments

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Inbound Licenses and Licensed IP Rights (see §9.3) fall within the definition of "general intangibles" for purposes of UCC Article 9. See Com C §9102(a)(42). Creating a security interest in Inbound Licenses and Licensed IP Rights is accomplished by a straightforward security agreement, but particular attention must be paid to Inbound Licenses that contain affirmative prohibitions on assignment or hypothecation, or are silent on the question of whether they can be assigned.

Most intellectual property licenses have provisions intended to prohibit the licensee from assigning or mortgaging the license or the licensee's rights under the license. A typical clause might read:

The Licensee may not assign, transfer, hypothecate, mortgage, or encumber this Agreement or any of its rights under this Agreement without the prior written consent of the Licensor.

Commercial Code §9408(a) renders a clause of this type "ineffective" to the extent that it prohibits *creating, attaching, or perfecting* a security interest in general intangibles. Specifically, Com C §9408(a) states:

> [A] term… in an agreement between an account debtor [*i.e.,* licensor] and a debtor [*i.e.,* licensee] that relates to a… general intangible, including a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of… the account debtor to, the assignment or transfer of, or the creation, attachment, or perfection of a security interest in, the… general intangible, is ineffective to the extent that the term does, or would do, either of the following:
>
> (1) It would impair the creation, attachment, or perfection of a security interest.
>
> (2) It provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the… general intangible.

By operation of Com C §9408(a), a licensee may grant a security interest in a license notwithstanding any provision that states otherwise, and the licensee will not be in breach of that license. This does not necessarily mean, however, that after an event of default the secured party can *foreclose* on, or exercise other remedies with respect to, its security interest or that, in bankruptcy, the license will be assumable, or assumable or assignable. See generally chap 12. On the contrary, Com C §9408(d)(6) provides in effect that prohibitions in Inbound Licenses against assignments remain effective when it comes time to foreclose and, in any event, give rise to a claim for damages from the contract breach.

PRACTICE TIP: Pre-2001 forms of security agreements often carve out of the granting clause without qualification any contracts that, if included, would cause the borrower to be in breach of those contracts. Today's forms of security agreements include this carve-out but limit it to breaches that are not overridden by §9408. An example of updated carve-out language is as follows:

> **<u>Certain Limited Exclusions.</u> Notwithstanding anything herein to the contrary, in no event shall the Collateral include or the security interest granted under Section _ _ hereof attach to (a) any lease, license, contract, property right, or agreement to which any Grantor is a party, or any of its rights or interests thereunder, if and for so long as the grant of such security interest shall constitute or result in (i) the abandonment, invalidation, or unenforceability of any right, title, or interest of any Grantor therein, or (ii) a breach or termination pursuant to the terms of, or a default under, any such lease, license, contract, property right, or agreement (other than to the extent that any such term would be rendered ineffective pursuant to Sections 9-406, 9-407, 9-408 or 9-409 of the UCC (or any successor provision) in any relevant jurisdiction or any other applicable law (including the Bankruptcy Code) or any principle of equity);**

provided, however, that the Collateral shall include, and at such time as the condition causing such abandonment, invalidation, or unenforceability is remedied and to the extent severable such security interest shall attach immediately to, any portion of such Lease, license, contract, property right or agreement that does not result any of the consequences specified in (i) or (ii) above….

A provision in a license that merely "impairs" but does not "restrict" the licensee's ability to create a security interest in the license is not necessarily rendered ineffective by Com C §9408. See Official Comment 6 to UCC §9-408. For example, a confidentiality clause that would be breached by mortgaging the license is, according to Official Comment 6 to UCC §9-408, merely an impairment, not a restriction and, as such, is not rendered ineffective by §9408.

PRACTICE TIP: Thus, a licensor that does not want its licensee to grant a security interest in the license and is concerned that Com C §9408 would override a contractual prohibition should consider including a confidentiality clause in the license that expressly prohibits disclosure of its existence or terms to any lender or potential lender of the licensee.

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§9.34 5. Intellectual Property Royalties and Receivables From Outbound Licenses

If the borrower is the licensor (*i.e.,* the license is an Outbound License), the borrower may wish to grant a security interest in its right to collect royalties or other license fees. Although the borrower's contractual rights under Outbound Licenses are themselves "general intangibles" under Com C §9102(a)(42), the royalties and other receivables from outbound intellectual property licenses are classified as "accounts." See Com C §9102(a)(2). They also constitute "proceeds" within Com C §9102(a)(64). Under Com C §9203(f), the attachment of a security interest in collateral gives the secured party the rights to proceeds as provided by Com C §9315.

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§9.35 6. IP Infringement Claims

An intellectual property infringement action is a form of tort claim, and business-related tort claims that do not involve personal injury are classified as "commercial tort claims" under Com C §9102(a)(13). This difference in categorization is important because, unlike other types of collateral that can be described simply by referring to the category name (*e.g.,* "general intangibles"), commercial tort claims must be specifically described. An infringement claim that is not sufficiently described will be excluded from the collateral. See Com C §9108(b), (e)(1); *Waltrip v Kimberlin* (2008) 164 CA4th 517, 528, 79 CR3d 460 (description of collateral by type is not sufficient for party to take security interest in commercial tort claim). A secured lender that wishes the collateral to include an infringement claim that the licensor (or other intellectual property owner) might have against another person or entity should ensure that the description of the claim refers to the alleged infringer and the nature of the infringement, and, if a case is actually pending, the case title, case number, and court where it is pending.

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§9.36 IV. PERFECTING INTELLECTUAL PROPERTY SECURITY INTERESTS

A secured party must perfect its security interest in order to defend it against the competing claims of third parties, including other secured parties, other transferees and creditors of the borrower, and the trustee in bankruptcy if the borrower files a bankruptcy case. See *Turbinator, Inc v Superior Court* (1995) 33 CA4th 443, 450, 39 CR2d 342. How perfection is achieved depends on what law governs the issue.

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A. What Law Governs?

§9.37 1. According to the UCC

Most security agreements contain a choice-of-law clause. As a general rule, UCC Article 9 (see Com C §9201) allows the parties to a security agreement to agree between themselves on what law will govern their transaction. See, *e.g., In re Gott* (Bankr ED Cal 1990) 114 BR 708, 710 n4; *In re Coldwave Sys., LLC* (Bankr D Mass 2007) 368 BR 91, 93. UCC Article 9 overrides contractual choice-of-law clauses on matters that affect the rights of third parties—mainly, perfection, effect of perfection, and priority of security interests.

With exceptions not applicable to IP Collateral, the rules set forth in Com C §9301 "determine the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral." Com C §9301. For most collateral, including intellectual property, the applicable law is the local law of the jurisdiction where the borrower is "located" (presumably excluding that jurisdiction's choice-of-law rules). Com C §9301(1); Official Comment 3 to UCC §9-301. See §9.38.

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§9.38 2. General Rule for Determining Borrower's Location

Commercial Code §9307 determines where the borrower is "located" for purposes of choice of law. If the borrower is a natural person, the location is where his or her principal residence is located. If the borrower is a "registered organization," *i.e.,* a corporation or limited liability company formed under the laws of a particular state, the borrower's location is its state of incorporation or formation. See Com C §9307(e); Official Comment 4 to UCC §9-307. If the borrower is an unregistered organization, its location is its place of business or, if it has more than one place of business, the place where its chief executive office is located. See Com C §9307(a)-(c), (e).

In sophisticated commercial transactions, most borrowers are corporations or limited liability companies. Many domestic corporations and limited liability companies are formed under Delaware law. For these entities, Article 9 of the Uniform Commercial Code of Delaware (6 Del Code §§9-101—9-709) will govern perfection and priority. For corporations and limited liability companies (and other "registered organizations") formed under California law, however, Division 9 will govern perfection and priority, unless preempted by federal law.

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§9.39 3. Federal Preemption Principles

Irrespective of Division 9's choice-of-law rules, federal preemption principles require courts to look to federal, rather than state, law if federal regulation is so pervasive as to indicate that "Congress left no room for supplementary state regulation," or if "the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject." *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194, 199. See also *PG&E v State Energy Resources Conserv. & Dev. Comm'n* (1983) 461 US 190, 203, 75 L Ed 2d 752, 103 S Ct 1713 (1983); *Sherwood Partners, Inc. v Lycos, Inc.* (9th Cir 2005) 394 F3d 1198.

Courts in the Ninth Circuit have held that the federal Copyright Act's recording provisions are sufficiently comprehensive to preempt state law methods of perfecting security interests in *registered* copyrights (and related accounts receivable). See, *e.g., National Peregrine, Inc.,* 116 BR at 199. It should be noted, however, that the Copyright Act does not contemplate recordation of documents relating to unregistered copyrights (see 17 USC §205(c)), and the Ninth Circuit has confirmed that perfection of security interests in *unregistered* copyrights is not governed by federal law. See *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120.

Perfection of security interests in patents and trademarks is not preempted by federal law. *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied (2002) 534 US 1130 (patents); *Roman Cleanser Co. v National Acceptance Co. (In re Roman Cleanser Co.)* (Bankr ED Mich 1984) 43 BR 940, aff'd (6th Cir 1986) 802 F2d 207 (trademarks).

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§9.40 B. Perfection Under Article 9 in General

The required method of perfecting a security interest under UCC Article 9 depends on the particular category of property into which the collateral falls. The major categories relevant to IP Collateral and the relevant portions of their UCC definitions are set forth in the table in §9.25. These categories of IP Collateral can be further divided into two groups: (1) those in which security interests are perfected under UCC Article 9 by filing a UCC-1 financing statement with the Secretary of State of the borrower's "location," and (2) those in which security interests are deemed to be perfected under UCC Article 9 when they attach.

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§9.41 1. Security Interests for Which UCC Article 9 Requires Filed Financing Statement

With one important exception, most forms of IP Collateral are "general intangibles" under Com C §9102(a)(42). The definition of "general intangible" includes rights that arise under a license of intellectual property, including the right to exploit the intellectual property without liability for infringement. Official Comment 5d to UCC §9-102. The sole exception is IP Licensing Revenue. IP Licensing Revenue is classified as an "account" under Com C §9102(a)(2), which is a different collateral category than a "general intangible."

Under Com C §9310(a), a security interest in a general intangible is perfected by filing a UCC-1 financing statement with the Secretary of State of the borrower's "location." A security interest in an account is also perfected by filing a financing statement with the applicable Secretary of State under Com C §9310(a). An Outbound License can be a "general intangible" or an "account," depending on its terms. Either way, a security interest in an Outbound License is perfected by filing a UCC-1 financing statement with the applicable Secretary of State.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.42 2. Security Interests Perfected on Attachment

§9.42 2. Security Interests Perfected on Attachment

The following types of security interests are deemed to be perfected under Com C §9309 when they attach, and accordingly do not require that a financing statement be filed or that any additional steps be taken for perfection. These types of security interests may be relevant to secured transactions involving intellectual property receivables or proceeds.

- A purchase money security interest in computer programs embedded in goods that are primarily for personal, family, or household use, except as otherwise provided in Com C §9311(b) with respect to consumer goods that are subject to a statute or treaty described in Com C §9311(a). However, filing a financing statement is required to perfect a non-purchase-money security interest in consumer goods and is necessary to prevent a buyer of consumer goods from taking free of a security interest under Com C §9320(b). See Official Comment 5 to UCC §9-320.
- An assignment of accounts or payment intangibles that does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles.

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§9.43 C. Perfection Under Other Law: When Required

Under UCC Article 9, the filing of a financing statement is "not necessary or effective" to perfect a security interest in property subject to a "statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt subdivision (a) of Section 9310." Com C §9311(a)(1). The drafters' comment to this section elaborates (Official Comment 2 to UCC §9-311):

> Subsection (a)(1) exempts from the filing provisions of this Article transactions as to which a system of filing —state or federal—has been established under federal law. Subsection (b) makes clear that when such a system exists, perfection of a relevant security interest can be achieved only through compliance with that system (i.e., filing under this Article is not a permissible alternative).

When the conditions of §9311(a)(1) are met, compliance with the requirements of that statute, regulation, or treaty "for obtaining priority over the rights of a lien creditor is equivalent to the filing of a financing statement under [UCC Article 9]." Com C §9311(b). Moreover (subject to exceptions not relevant to IP Collateral), a security interest in property subject to such a statute, regulation, or treaty "may be perfected only by compliance with those requirements, and a security interest so perfected remains perfected notwithstanding a change in the use or transfer of possession of the collateral." Com C §9311(b). Lastly, the duration (and renewal) of perfection of a security interest that is perfected in accordance with such a statute, regulation, or treaty is governed by that statute, regulation, or treaty, but in other respects, the security interest is subject to UCC Article 9. Com C §9311(c).

With IP Collateral, the question is whether it is covered by a "statute, regulation or treaty" of the type described in §9311(a). The answer is that it depends on what type of IP Collateral is involved. Sections 9.44-9.64 explain the requirements for perfection of security interests in particular types of IP Collateral and, in particular, whether or not the form of IP Collateral is, based on existing Ninth Circuit case law, subject to a "statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property" preempt Article 9.

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D. Patents and Related Assets

1. Patents and Patent Applications

§9.44 a. Governing Law

Under §261 of the Patent Act (35 USC §261, emphasis added):

> Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States….
>
> An *assignment, grant or conveyance* shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

The Patent Rules define "assignment" as "a transfer by a party of all or part of its right, title and interest in a patent, patent application, registered mark or a mark for which an application to register has been filed." 37 CFR §3.1. In *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied (2002) 534 US 1130, the Ninth Circuit Court of Appeals held that the grant of a security interest in a patent is not an "assignment, grant or conveyance" within the meaning of §261 of the Patent Act because it does not give the secured party full title to (or transfer ownership of) the patent. Therefore, the court concluded, the Patent Act does not preempt Article 9 insofar as perfection of a security interest is concerned. The court also held that even if the grant of a security interest were covered by §261, the bankruptcy trustee would not displace the patent holder because §261 only protects a subsequent holder of an *ownership* interest in a patent, not a lien creditor or a person such as the bankruptcy trustee standing in the shoes of a lien creditor. The court held that the term "mortgagee" in §261 was an outdated term meaning one who holds legal title. See 252 F3d at 1053. See also *Rhone-Poulenc Agro, S.A. v DeKalb Genetics Corp*. (Fed Cir 2002) 284 F3d 1323, 1333, cert denied (2003) 539 US 957 (only purchaser or mortgagee of "assignment, grant or conveyance" can claim protection as bona fide purchaser).

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§9.45 b. Required State Filing: UCC-1 Financing Statement at Secretary of State

Based on the authorities discussed in §9.44, a secured party must file a UCC-1 financing statement covering general intangibles at the office of the Secretary of State in order to perfect a security interest in a patent. Merely recording the security agreement in the PTO will not result in perfection of the security interest. See *Moldo v Matsco, Inc.* (*In re Cybernetic Servs., Inc.*) (9th Cir 2001) 252 F3d 1039, 1057, cert denied (2002) 534 US 1130. The same is true for patent applications. See *Holt v U.S.* (D DC 1973) 73-2 USTC ¶9680, 32 AFTR2d 5744. The filing must be made at the borrower's location, as determined under Com C §9307.

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§9.46 c. Recommended Federal Filing: Conditional Patent Assignment or Patent Security Agreement

In addition to the state-level filing discussed in §9.45, a filing at the PTO is recommended to ensure that the holder of the security interest will trump any prior unrecorded purchasers of the patent or patent application. A PTO filing of either the security agreement or a title-bearing conditional assignment can also be useful to put a bona fide purchaser on inquiry notice or constructive notice, as applicable, of the lender's security interest. See §§9.47-9.48. Recordation of the security agreement would only constitute notice if the subsequent purchaser in fact searched the PTO records and found the filing. By comparison, recordation of a conditional assignment that constitutes an "assignment, grant or conveyance" subject to §261 of the Patent Act puts a subsequent purchaser on constructive notice of its contents. See Ward, Intellectual Property in Commerce §§2:24, 2:97-2:98, n6 (West Group 2009).

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§9.47 (1) Conditional Assignment Preferred

Based on the Patent Rules and the MPEP provisions discussed below, most commentators recommend that a lender taking a security interest in patents and patent applications make a recording at the PTO as well as the required UCC-1 financing statement filing. Ideally, the document recorded should take the form of a conditional assignment—an assignment to the secured lender subject to a condition subsequent that it will be reversed on repayment by the borrower of the loan in full. As a fallback, the lender should record a patent security agreement coupled with a transfer statement and power of attorney authorizing the lender to execute and record the transfer statement. See Apps D-1, D-8, and D-9. A transfer statement is a document obtained at the time the loan is made that can be recorded after an event of default without need for any additional authorization from the borrower. It is used to effect transfer of the collateral to the debtor when the collateral is subject to a registration or recordation scheme. Uniform Commercial Code §9-619 specifically provides for a "transfer statement" that can be signed by the secured party acting alone. See Ward, Intellectual Property in Commerce §3:70 (West Group 2009). A sample form of transfer statement is presented in App D-9.

The benefit of recording at the PTO is to lessen the risk that a subsequent bona fide purchaser of the patent or patent application (someone who purchases for valuable consideration and without knowledge of the earlier security interest) who records its purchase document will take free of the earlier security interest. The rights of bona fide purchasers relative to earlier secured lenders are discussed in §9.69. A conditional assignment is still likely to be viewed as a security interest for purposes of the UCC Article 9 provisions that govern what a secured lender must do when exercising its remedies if the borrower defaults. See §§9.74-9.85.

The rules promulgated under the Patent Act (37 CFR §§1.1-1.997) (Patent Rules), and the PTO's Manual of Patent Examining Procedure (8th ed 2001, rev 2008) (MPEP) provide that a security agreement is a document that "affects" patent title, and therefore the PTO may in its discretion accept it for filing. Both the Patent Rules and the MPEP distinguish between documents that will be accepted by the PTO director and those that, in the director's discretion, might be accepted for filing (37 CFR §3.11(a), emphasis added):

> Assignments of applications, patents, and registrations, accompanied by completed cover sheets as specified in [the rules], will be recorded in the Office. Other documents, accompanied by completed cover sheets as specified in [the rules], affecting title to applications, patents, or registrations, will be recorded as provided in this part or *at the discretion of the Director*.

The corresponding section of the MPEP states (MPEP §313):

> [S]ome documents which relate to patents or applications will be recorded, although they do not constitute a transfer or change of title. Typical of these documents which are accepted for recording are license agreements and agreements which convey a security interest. Such documents are recorded in the public interest in order to give third parties notification of equitable interests or other matters relevant to the ownership of a patent or application.

Third parties are only charged with notice of documents filed at the discretion of the director if such third parties can be shown to have reviewed the PTO records. In contrast, recording a document that the director is required to accept for filing, such as an assignment, puts third parties on notice of its contents irrespective of whether the third parties actually reviewed the PTO records. See 37 CFR §§3.11, 3.54; MPEP §317.03. See also Ward, Intellectual Property in Commerce §2:98 n6 ("If the secured party took and recorded a security agreement instead of a title-bearing conditional assignment, it would not get the absolute record protection afforded a recorded conditional assignment"). MPEP §317.03 provides that a security agreement that does not convey any right, title, or interest in a patent is not a conditional assignment. Accordingly, a lender who wishes to assure that prior unrecorded assignments will give way to their subsequently granted security interests should, for purposes of §261 of the Patent Act, record an outright or conditional assignment of title instead of a mere security agreement.

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§9.48 (2) Issues With Conditional Assignments

Taking a patent assignment (arguably even one that purports to be "conditional") requires the lender to license the right to practice the patent back to the borrower to avoid placing the borrower in the position of infringing the patent. In addition, the assignment should include a promise by the borrower to indemnify the lender if the lender is sued for claims that arise from owning the patent, such as claims for infringement, conversion, or misappropriation. The lender as conditional assignee will probably need to join any actions for damages in an offensive lawsuit alleging infringement by third parties of the patent and should be prepared to be sued in any defensive lawsuit alleging infringement by the licensee. See Ward, Intellectual Property in Commerce §2:103 n1 (West Group 2009). The lender will also likely have to be prepared to maintain the patent, absent a promise by the borrower to do so, as the PTO treats conditional assignments as "absolute." See 37 CFR §3.56. Most importantly, for Article 9 purposes (in contrast to Patent Act §261), the conditional assignment is still likely to be treated as a security agreement—because this is its real intent—and the lender's exercise of remedies if the borrower defaults will therefore be subject to the borrower protections of Article 9.

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§9.49 2. Inbound Patent Licenses and Licensed Rights

Inbound licenses of patents and patent rights are classified as "general intangibles" under Com C §9102(a)(42). The Patent Act does not contain any provisions by which the holder of a security interest in an inbound patent license could obtain priority over a lien creditor of the licensee. Accordingly, to perfect a security interest in a borrower's inbound patent license (and related licensed rights), the lender must file a UCC-1 financing statement at the borrower's location. See Com C §§9307, 9310(a).

A licensee of a patent takes subject to any prior licenses, liens, or other encumbrances against the patent. Nonetheless, lenders sometimes record security agreements covering inbound patent licenses and related rights with the PTO in an effort to lessen the risk that a subsequent bona fide purchaser of the underlying patent would claim ignorance of the lender's security interest and try to displace it. Such a PTO recording is not necessary for perfection, nor is it helpful or hurtful. The rights of bona fide purchasers in relation to the rights of prior secured lenders are discussed in §9.69.

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§9.50 3. Royalties and Receivables From Outbound Patent Licenses

The Patent Act does not contain any provisions by which the holder of a security interest in IP Licensing Revenue or Outbound Licenses of patents (see §9.3) could obtain priority over a lien creditor of the licensor. Accordingly, UCC Article 9 alone governs perfection of a security interest in these types of patent IP Collateral.

IP Licensing Revenue is an "account" under UCC Article 9. See Com C §9102(a)(2). When the IP Collateral includes the Pure IP Assets or IP Rights that generate the IP Licensing Revenue, the IP Licensing Revenue also constitutes "proceeds" under Com C §9102(a)(64), because the definition of "proceeds" includes whatever is acquired from licensing (as well as from selling) the collateral. See Com §9102(a)(64)(A).

A security interest in an account is perfected by filing a financing statement at the borrower's location. See Com C §§9307, 9310(a). A security interest in proceeds is automatically perfected without any further action if the security interest in the original collateral was perfected. Com C §§9310(b)(9), 9315(c). However, a security interest perfected in proceeds by virtue of a perfected security interest in the original collateral can become unperfected. Under Com C §9315(d), such a security interest will become unperfected on the 21st day after it attaches to the proceeds unless: (1) (a) a filed financing statement covers the original collateral, (b) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed, and (c) the proceeds were not acquired with cash proceeds; or (2) the proceeds are identifiable (*i.e.,* not commingled) cash proceeds.

In some cases, the secured lender may actually purchase the borrower's accounts rather than taking a security interest in them. If so, the borrower's licensee or sublicensee constitutes the "account debtor" on any such account (see Com C §9102(a)(3)) and is the person obligated to pay the IP Licensing Revenue to the secured lender. Notifying the account debtor on such an account is not sufficient for the secured party to perfect its interest in the account. Instead, a UCC-1 financing statement must be filed in accordance with Com C §9310(a).

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§9.51 E. Copyrights and Related Assets

How a secured lender perfects a security interest in a copyright depends on whether the copyright has been registered with the Copyright Office or is unregistered. See *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.*) (9th Cir 2002) 303 F3d 1120, 1125.

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§9.52 1. Registered Copyrights (and Applications for Copyright Registrations)

In *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.*) (9th Cir 2002) 303 F3d 1120, the Ninth Circuit Court of Appeals held that the recordation and priority scheme of the Copyright Act (17 USC §§101-1332) is the type of filing system that, under Com C §9311(a)(1) (former Com C §9302(3)(a)), controls perfection and priority of security interests in *registered* copyrights, and therefore preempts UCC Article 9 in that respect. Hence, a security interest in a *registered* copyright (or an application for a copyright registration) can be perfected only by filing a security agreement in the Copyright Office.

The *Aerocon* decision carefully limited the prior Ninth Circuit case precedent, *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n* (*In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194. In *Peregrine,* the collateral consisted of a library of 145 films and the accounts receivable from licensing of the films. The lender filed a UCC-1 financing statement at the state level but did not record a copyright security agreement with the Copyright Office. The borrower's successor by merger filed a Chapter 11 case and, as debtor in possession, contended that the lender's security interest was unperfected. In a decision authored by Justice Alex Kozinski of the Ninth Circuit sitting by designation, *Peregrine* held that the only way to perfect a security interest in copyrights is to record the security agreement in the Copyright Office, because the Copyright Act preempts UCC Article 9 on the question of perfection and priority of security interests. The decision also extended to accounts receivable that arise from licensing copyrights. The *Aerocon* case, however, limited the *Peregrine* holding to security interests in *registered* copyrights only. The Ninth Circuit in *Aerocon* expressly rejected the view of the courts in *Peregrine* and in *In re Avalon Software Inc.* (Bankr D Ariz 1997) 209 BR 517 and *Official Unsecured Creditors' Comm. v Zenith Prods., Ltd. (In re AEG Acquisition Corp.)* (Bankr CD Cal 1991) 127 BR 34, aff'd (BAP 9th Cir 1993) 161 BR 50, that a security interest in an *unregistered* copyright could be perfected only by first registering the copyright and then filing a security agreement in the Copyright Office. *Aerocon*, 303 F3d at 1130. At present, Ninth Circuit law is that security interests in registered copyrights can be perfected only by filing the security agreement in the Copyright Office.

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§9.53 2. Unregistered Copyrights

A copyrighted work only receives a title or registration number that would be revealed by a search of Copyright office records if it is registered. Because an unregistered work cannot be searched by registration number, recording a security interest in an unregistered copyright in the Copyright Office would not give constructive notice of its existence. *Aerocon Eng'g Inc*. *v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120, 1126. Therefore, to perfect a security interest in an unregistered copyright, the secured party need only (and can only) file a UCC-1 financing statement covering general intangibles at the borrower's location. Federal law does not preempt state methods of perfection with respect to unregistered copyrights. *Aerocon Eng'g Inc*. *v Silicon Valley Bank (In re World Auxiliary Power Co.), supra*.

In *Aerocon,* the collateral included copyrights on software, drawings, blueprints, and a variety of other materials protected by copyright but highly confidential and therefore not registered at the Copyright Office. The borrowers filed UCC-1 financing statements with the California Secretary of State, but to protect confidentiality made no filings at the Copyright Office. The court recognized that if the underlying work has not been registered, there is no registration number that can be searched to determine whether a copyright mortgage or security agreement has been recorded against the work—only recorded documents that relate to registered copyrights can provide constructive notice of their contents.

PRACTICE TIP: Filing a UCC-1 financing statement to perfect a security interest in an unregistered copyright is deceptively simple but fraught with danger. The secured lender should consider requiring the borrower, as a condition to closing, to register critically important copyrighted works at the Copyright Office to avoid the risk that the lender's security interest would become unperfected as described in §9.54. At a minimum, the lender should include a covenant in its loan or security agreement prohibiting the borrower from registering any previously unregistered copyrights without first giving the secured party prior notice and the opportunity to record its security interest concurrently with the filing of the application for registration and again against the registration after it issues and a copyright registration number has been assigned to the work. Even then, the secured lender should conduct regular searches of Copyright Office records to confirm that no registrations of previously unregistered copyrights have been made without the lender's consent.

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§9.54 3. Unregistered Copyrights That Are Later Registered

What happens if a borrower grants its lender a security interest in an unregistered copyright, the lender files a financing statement at the state level, and then the borrower later registers the underlying work? Based on the federal district court opinion in *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (Bankr ND Cal 1999) 244 BR 149, aff'd (9th Cir 2002) 303 F3d 1120, the answer appears to be that the lender's security interest in the unregistered copyrights could become unperfected. The district court opinion in *Aerocon* noted that perfection by a financing statement filing "would be vulnerable to invalidation if a copyright were later registered and a competing security interest in the copyright had been recorded in the Copyright Office." 244 BR at 154 n11. The security interest might even become unperfected at the time an unregistered work is registered, regardless of whether a competing security interest was recorded in the meantime. See*, e.g., Fortune Finans AB v Andersson* (Sup Ct 1993) 600 NYS2d 460 (security interest in painting that was perfected but, on being moved, became unperfected under Swiss law held to be unperfected under U.S. law). As a consequence, lenders should consider prohibiting borrowers from registering previously unregistered copyright collateral without giving prior notice to the lender and affording the lender a chance to record its security agreement in the Copyright Office.

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§9.55 4. Inbound Copyright Licenses and Licensed Rights

Under the Copyright Act, an exclusive copyright license constitutes a transfer of an interest in copyright. See definition of "transfer of copyright ownership" in 17 USC §101. Accordingly, a secured creditor must treat a security interest in an exclusive copyright license in the same way as a security interest in the copyright itself. If the underlying copyright is registered, the secured creditor must record its security agreement in the Copyright Office; if the underlying copyright is unregistered, filing a UCC-1 financing statement is required. See §§9.52-9.53.

PRACTICE TIP: As in the case of a security interest in a registered copyright, a secured creditor with a security interest in an exclusive license to a registered copyright should as a precautionary matter also file a UCC-1 financing statement at the state level.

In comparison, a nonexclusive copyright license represents only the right to use the copyrighted work in the manner specified in the license, and not a transfer of an ownership interest in the copyright. See definition of "transfer of copyright ownership" in 17 USC §101. Accordingly, a security interest in a nonexclusive copyright license can only be perfected by filing a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a).

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§9.56 5. Royalties and Receivables From Outbound Copyright Licenses

Courts differ on whether a secured lender must file a security agreement with the Copyright Office to perfect a security interest in IP Licensing Revenue from outbound copyright licenses. As discussed in §9.52, the Ninth Circuit Court of Appeals in *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120 overruled both *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n* (*In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194 and *In re Avalon Software Inc.* (Bankr D Ariz 1997) 209 BR 517 to the extent that they held that a Copyright Office filing is necessary to perfect a security interest in unregistered copyrights. Copyright license receivables were not at issue in *Aerocon,* however; thus, application of the *Aerocon* decision to royalties and receivables from copyright licenses is unclear.

In *Peregrine,* the court held that, because a copyright entitles its owner to receive all income derived from display of the creative work, a security interest in receivables generated by copyrighted work may only be perfected by a Copyright Office filing. But see *MCEG Sterling, Inc. v Phillips Nizer Benjamin Krim & Ballon* (Sup Ct 1996) 646 NYS2d 778, 780 (questioning *Peregrine* holding as to accounts receivable). As noted in §9.52, the collateral in *Peregrine* was a library of films that were undoubtedly registered with the Copyright Office, but the court did not explain whether this fact affected its analysis.

In *In re Avalon Software Inc., supra,* the court applied the reasoning of *Peregrine* to hold that a security interest in accounts arising from copyrighted works could only be perfected by filing a security agreement in the Copyright Office, rather than by filing a UCC-1 financing statement. The copyrighted works in *Avalon Software* consisted of *unregistered* software modifications. In view of the Ninth Circuit's decision in *Aerocon* rejecting the *Avalon Software* holding as applied to unregistered copyrights, the continuing precedential value of the *Avalon Software* holding with respect to unregistered copyright receivables is doubtful.

In *Broadcast Music, Inc. v Hirsch* (9th Cir 1997) 104 F3d 1163, the court held that it was not necessary to record outright assignments of copyright royalties in the Copyright Office because the assignments did not amount to "transfers of copyright ownership" or "other documents pertaining to a copyright" subject to the recordation requirements of the Copyright Act. See 17 USC §205(a). In *Broadcast Music,* the party entitled to collect the receivables no longer held any ownership interest in the underlying copyright, prompting the court to observe, "there is no evidence that [the party who assigned the receivables] owned a copyright and had a security interest he could assign. Rather, this is a case of outright assignments of a right to receive royalties for the purpose of satisfying a debt." 104 F3d at 1166.

PRACTICE TIP: Given the uncertainty regarding whether perfection of a security interest in copyright receivables is preempted by the Copyright Act, a lender with a security interest in registered or unregistered copyright licensing revenue should record a security agreement covering any registered copyrights in the Copyright Office and also file a UCC-1 financing statement at the borrower's location. The prudent lender might also consider filing a UCC-1 financing statement at the location of the borrower's material licensees and sublicensees.

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F. Trademarks, Domain Names, and Related Assets

§9.57 1. Common Law Trademarks and Federal and State Trademark Registrations

The Trademark Act of 1946 (Lanham Act), 15 USC §§1051-1127, contains only the following provision on recording transfers of interests in trademarks (15 USC §1060, emphasis added):

> An *assignment* [of a trademark registration or application for registration (other than an intent-to-use application)] shall be void against any subsequent purchaser for valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the [PTO] within 3 months after the date of the assignment or prior to the subsequent purchase.

Because the Lanham Act (like the Patent Act; see §9.44) refers only to *assignments,* and not to mortgages or security interests, the Lanham Act does not preempt the UCC on matters of perfection of security interests. Hence, to perfect a security interest in an unregistered or registered trademark (or applications for trademark registration that are not based merely on an intent to use the marks), a lender must file a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a). *Joseph v 1200 Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778, 782. See also *Creditors' Comm. of TR-3 Indus., Inc. v Capital Bank (In re TR-3 Indus.)* (Bankr CD Cal 1984) 41 BR 128, 131 (purpose of Lanham Act is not to provide method for perfection of security interests).

PRACTICE TIP: Although a state-level UCC filing is sufficient to perfect a security interest in a trademark, a lender might express concern that a subsequent purchaser of a registered trademark would take free of the security interest unless the security agreement is recorded at the PTO. The lender might also ask the borrower to enter into either an outright or a conditional trademark assignment that the lender could record at the PTO to put third parties on notice of the lender's interest. See §9.47. As a general rule, the borrower should not agree to this (and the lender should not request it) because an assignment of the trademark without a transfer of other assets representing goodwill of the borrower's business would constitute an assignment in gross and, if challenged, could invalidate the trademark. See §9.8. Instead, the lender can record a trademark security agreement at the PTO. See App D-2. The trademark security agreement can be coupled with a transfer statement (see §9.47) and include a power of attorney in the trademark security agreement that entitles the lender to execute and record the transfer statement in the event of default. The transfer statement can be attached as an exhibit to the trademark security agreement and, if the lender wishes, can also be recorded at the PTO. See App D-9 for a sample form of transfer statement.

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§9.58 a. Required State Filing: UCC-1 Financing Statement at Secretary of State

Common law, state-registered, and federally registered trademarks, as well as applications for trademark registration (to the extent security interests in such applications can be granted; see §9.57), all constitute "general intangibles" under UCC Article 9. See Com C §9102(a)(42). Filing a UCC-1 financing statement is therefore required under Com C §9310(a) to perfect a security interest in all types of trademarks. The filing must be made at the borrower's location, as determined under Com C §9307.

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§9.59 b. Recommended Federal Filing: Trademark Security Agreement at PTO

For federally registered trademarks and any applications for federal trademark registration included in the collateral, a filing at the PTO is recommended to give bona fide purchasers of the mark (or application) constructive notice of the lender's security interest. A short form trademark security agreement (similar to the form in App D-2) can be used for this purpose. As discussed in §9.57, as a general rule, to lessen the risk of invalidation of a mark through a possible assignment in gross, the lender should not request, and the borrower should not agree to enter into, either an outright or a conditional assignment of the trademark registration to the lender.

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§9.60 2. Inbound Trademark Licenses and Licensed Rights

An inbound trademark license is a "general intangible" under UCC Article 9. See Com C §9102(a)(42). Neither the Lanham Act nor any other federal statute includes provisions by which a security interest in an inbound trademark license can obtain priority over the rights of a lien creditor with respect to the license. See Com C §9311(a)(1); §9.43. Accordingly, perfection of a security interest in an inbound trademark license is governed exclusively by UCC Article 9. To perfect a security interest in a borrower's inbound license for a registered trademark, the lender must simply file a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a).

PRACTICE TIP: Although the law is clear that the way to perfect a security interest in an inbound trademark license is by filing a UCC-1 financing statement**,** if the trademark covered by the license is registered, the lender may ask to record its security agreement with the PTO in order to lessen the risk that a subsequent purchaser of the underlying trademark would claim ignorance of the security interest and seek to displace it. Recording a trademark security agreement at the PTO should give third parties inquiry notice (although not constructive notice) of its contents—*i.e.,* persons who in fact search the PTO records will be charged with knowing their contents. The rights of bona fide purchasers relative to earlier secured lenders are discussed in §9.96.

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§9.61 3. Trademark Royalties and Receivables From Outbound Licenses of Trademarks

As in the case of inbound trademark licenses (see §9.60), neither the Lanham Act nor any other federal statute contains provisions by which a security interest in trademark royalties or receivables (IP Licensing Revenue; see §9.3) under an outbound trademark license obtains priority over the rights of a lien creditor in the same collateral. See Com C §9311(a)(1); §9.43. Accordingly, UCC Article 9 alone governs perfecting a security interest in this form of trademark IP Collateral.

IP Licensing Revenue from trademark licenses is an "account" under UCC Article 9. See Com C §9102(a)(2). When the IP Collateral includes the Pure IP Assets or IP Rights (see §9.3) that generate the IP Licensing Revenue, the IP Licensing Revenue is also "proceeds" under Com C §9102(a)(64), because the term "proceeds" is defined to include whatever is acquired, not merely from selling, but also from licensing collateral. See Com C §9102(a)(64).

A security interest in an "account" is perfected by filing a financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a). A security interest in proceeds is automatically temporarily perfected without any further steps if the security interest in the original collateral was perfected. Com C §9315(c)-(d). A security interest in proceeds perfected by virtue of a perfected security interest in the original collateral, however, can become unperfected. Under Com C §9315(d), such a security interest in proceeds becomes unperfected on the 21st day after it attaches to the proceeds unless (1) (a) a filed financing statement covers the original collateral, (b) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed, and (c) the proceeds are not acquired with cash proceeds; or (2) the proceeds are identifiable (not commingled) cash proceeds.

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4. Domain Names

§9.61A a. Perfection as a Trademark

There is no federal statute that governs the creation and perfection of a security interest in a domain name. However, given the dual function of domain names as both Internet address identifiers and as source identifiers, domain name owners can look to common law and state and federal trademark rights for the creation of a security interest so long as all applicable requirements for registering a trademark are satisfied. Accordingly, a domain name that qualifies as a trademark can be perfected under the same federal and state rules applicable to trademarks. See §§9.57-9.61.

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§9.61B b. Perfection in the Absence of a Trademark

Regardless of whether a domain name is classified as a trademark or even as "property," it can be perfected as a separately enforceable right for secured lending purposes. A properly registered domain name is an enforceable right because of the priority and exclusivity over the domain name that arises from the registration agreement between the registrar and the registrant. See Ward, Intellectual Property in Commerce §1:14 (West Group 2009). Although Division 9 does not specifically define a domain name as a "general intangible," it is the promise-based right in priority and exclusivity that has the legal status of a general intangible under Division 9. See Com C §9102(a)(42) and Official Comment 5(d). Accordingly, a security interest in a general intangible is perfected by filing a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a).

PRACTICE TIP: In addition to capturing rights to the domain name itself, a lender should also seek to capture rights in the domain name's corresponding registration agreement and any proceeds from the domain name's use. Accordingly, the description of a domain name in the financing statement should reference (1) the domain name itself; (2) any trademarks and associated goodwill related to the domain name; (3) any accounts receivable, accounts, instruments, general intangibles, and payment intangibles arising from or related to the domain name's use; and (4) any proceeds from the sale or disposition of the domain name.

It is important to note that some domain name registration agreements prohibit assignment of the registrant's rights under the agreement. However, Division 9 provides that these non-assignment provisions are ineffective to prevent the creation, attachment, or perfection of a security interest in a general intangible. See Com C §9408(a). One important caveat is that the security interest is not enforceable by the lender against the non-debtor party (*i.e.,* the registrar). See Com C §9408(d). However, a lender's perfected status over a domain name will still be recognized against other creditors, and in bankruptcy, and the lender will be entitled to proceeds from the sale of the domain name.

PRACTICE TIP: In some cases, the issue of non-assignability can be resolved when a lender becomes both the registrant and the administrative contact. This status can be achieved by requiring the borrower to transfer the domain name under the lender's name for the term of the loan with a license back to the borrower. This will allow the lender to: (1) control the domain name; (2) ensure it is maintained and renewed; (3) prevent any unauthorized transfers; and (4) provide the lender with notice of any infringement claims or other complaints arising from the domain name's use.

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G. Trade Secrets and Related Assets

§9.62 1. Trade Secrets

There is no federal statute governing trade secrets. Therefore, UCC Article 9 alone governs perfection of security interests in a trade secret. See Com C §9311(a)(1); §9.43. A trade secret is a "general intangible" under UCC Article 9. See Com C §9102(a)(42); Official Comment 5d to UCC §9-102; *Smith v Iron & Glass Bank (In re: SSE Int'l Corp*.) (Bankr WD Pa 1996) 198 BR 667 (when subject of security agreement is "debtor's know-how," UCC-1 financing statement is sufficient to validly perfect such interest). To preserve the "secret" quality of a trade secret, the trade secret should not be described in great detail. Because many types of information can be protected as trade secrets, however, descriptions more specific than "general intangibles" or "trade secrets" should be used.

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§9.63 2. Inbound Trade Secret Licenses and Licensed Rights

Inbound trade secret licenses and licensed rights are "general intangibles" under UCC Article 9. See Com C §9102(a)(42). No federal law addresses provisions for a security interest's obtaining priority over the rights of a lien creditor with respect to such licenses and rights. Accordingly, UCC Article 9 alone governs perfection. See Com C §9311(a)(1); §9.43. To perfect a security interest in a borrower's inbound trade secret license and licensed rights, the lender must file a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a). See Official Comment 5d to UCC §9-102; *Smith v Iron & Glass Bank (In re: SSE Int'l Corp*.) (Bankr WD Pa 1996) 198 BR 667 (debtor's rights under license must be perfected by filing UCC-1 financing statement covering "general intangibles").

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§9.64 3. Trade Secret Royalties and Receivables From Outbound Licenses

No federal statute contains provisions by which a security interest in royalties or other receivables from an outbound trade secret license can obtain priority over the rights of a lien creditor with respect to the same collateral. Accordingly, UCC Article 9 alone governs perfection of a security interest in such collateral. See Com C §9311(a)(1); §9.43. IP Licensing Revenue from an outbound trade secret license is an "account" under Article 9. See Com §9102(a)(64). When the IP Collateral includes the Pure IP Assets or IP Rights that generate the IP Licensing Revenue, the IP Licensing Revenue also constitutes "proceeds" under Com §9102(a)(64), because "proceeds" is defined to include whatever is acquired, not merely from selling, but also from licensing collateral. See Com §9102(a)(64).

A security interest in an "account" is perfected by filing a financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a). A security interest in proceeds is automatically temporarily perfected without any further steps if the security interest in the original collateral was perfected. Com C §9315(c)-(d). A security interest perfected in proceeds by virtue of a perfected security interest in the original collateral, however, can become unperfected. See Com C §9315(d). Under §9315(d), such a security interest in proceeds becomes unperfected on the 21st day after it attaches to the proceeds unless (1) (a) a filed financing statement covers the original collateral, (b) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed, and (c) the proceeds are not acquired with cash proceeds; or (2) the proceeds are identifiable (not commingled) cash proceeds.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.65 H. Summary of Perfection Methods

§9.65 H. Summary of Perfection Methods

The following table summarizes the required and recommended methods of perfecting security interests in the various forms of IP Collateral. Recommended measures are bracketed.

COLLATERAL TYPE	WHERE TO FILE	WHAT TO FILE
Patent or Patent Application	State of Borrower's Location [PTO]	State: UCC-1 Financing Statement [PTO: Conditional Patent Assignment or, as fallback, Patent Security Agreement]
Inbound Patent License—Exclusive	State of Borrower's Location [PTO]	UCC-1 Financing Statement [PTO: Patent Security Agreement]
Inbound Patent License—Nonexclusive	State of Borrower's Location [PTO]	State: UCC-1 Financing Statement [PTO: Patent Security Agreement]
Patent Licensing Revenue and Outbound Patent License	State of Borrower's Location [State of Licensee's Location] [PTO]	State: UCC-1 Financing Statement [PTO: Patent Security Agreement]
Copyrights—Registered	Copyright Office [State of Borrower's Location]	Copyright Office: Copyright Security Agreement State: UCC-1 Financing Statement
Copyrights—Unregistered	State of Borrower's Location [District of Columbia]	UCC-1 Financing Statement
Inbound Registered Copyright License—Exclusive	Copyright Office State of Borrower's Location	Copyright Office: Exclusive Copyright License Security Agreement State: UCC-1 Financing Statement
Inbound Registered Copyright License—Nonexclusive	State of Borrower's Location	State: UCC-1 Financing Statement
Copyright Licensing Revenue and Outbound Copyright License—Registered	Copyright Office State of Borrower's Location [State of Licensee's Location]	Copyright Office: Copyright Receivables Security Agreement State: UCC-1 Financing Statement
Copyright Licensing Revenue and Outbound Copyright License—	State of Borrower's Location [State of Licensee's Location]	State: UCC-1 Financing Statement

Unregistered		
Trademarks—Federally Registered	State of Borrower's Location [PTO]	State: UCC-1 Financing Statement PTO: Trademark Security Agreement
Trademarks—State Registered	State of Borrower's Location [State of Trademark Registration]	State: UCC-1 Financing Statement State Trademark Office: Trademark Security Agreement
Trademarks—Unregistered	State of Borrower's Location	UCC-1 Financing Statement
Inbound Federally Registered Trademark License—Exclusive	State of Borrower's Location [PTO]	State: UCC-1 Financing Statement [PTO: Exclusive Trademark License Security Agreement]
Inbound Federally Registered Trademark License—Nonexclusive	State of Borrower's Location [PTO]	State: UCC-1 Financing Statement [PTO: Nonexclusive Trademark License Security Agreement]
Inbound State Registered Trademark License— Exclusive	State of Borrower's Location [State of Trademark Registration]	State: UCC-1 Financing Statement [State Trademark Office: Exclusive Trademark License Security Agreement]
Inbound State Registered Trademark License—Nonexclusive	State of Borrower's Location [State of Trademark Registration]	State: UCC-1 Financing Statement [State Trademark Office: Nonexclusive Trademark License Security Agreement]
Trademark Licensing Revenue and Outbound Trademark License—Federally Registered	State of Borrower's Location [State of Licensee's Location] [PTO]	State: UCC-1 Financing Statement [PTO: Trademark Security Agreement]
Trademark Licensing Revenue and Outbound Trademark License—State Registered	State of Borrower's Location [State of Licensee's Location] [State of Trademark Registration]	State: UCC-1 Financing Statement State Trademark Office: Trademark Receivables Security Agreement
Trademark Licensing Revenue and Outbound Trademark License—Unregistered	State of Borrower's Location [State of Licensees' Location]	State: UCC-1 Financing Statement
Trade Secrets	State of Borrower's Location	UCC-1 Financing Statement
Inbound Trade Secret License—Exclusive or Nonexclusive	State of Borrower's Location	UCC-1 Financing Statement
Trade Secret Licensing Revenue	State of Borrower's Location	State: UCC-1 Financing Statement

and Outbound Trade Secret License—Exclusive or Nonexclusive	[State of Licensee's Location]	

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§9.66 V. DETERMINING PRIORITY OF INTELLECTUAL PROPERTY SECURITY INTERESTS

Determining who prevails in the case of conflicting assignments, licenses, and security interests involving the same IP Collateral is perhaps the most confusing aspect of secured transactions involving intellectual property. The confusion stems from many sources. First, the analysis depends on the precise type of IP Collateral at issue, yet multiple types of IP Rights are often embodied in the same goods, services, or technology serving as collateral for the loan. Second, it is not always clear what substantive laws, or even what choice-of-law rules, govern the issue of priority. UCC Article 9 requires looking to federal law when federal law preempts state law on the question of perfection and priority of security interests. See Com C §9311(a)(1); §9.43. Commercial Code §9311(a)(1) implies that federal law preempts state law only when state law says so, but this is not correct under general federal preemption principles. See §9.39. The discussion of priorities in §§9.67-9.97 illustrates some of the problems that can arise and suggests ways that practitioners can try to anticipate and resolve them.

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A. Applicable Law

1. Priority Rules Under UCC Article 9

§9.67 a. General Rule

Commercial Code §9322 sets forth the basic rules for determining priority between conflicting security interests. Insofar as IP Collateral is concerned, the basic rules are as follows:

- As between two security interests that are both perfected (see Com C §9308), the security interest that has priority is the earlier of the first to file or the first to be perfected, provided that there is no period thereafter when there is neither filing nor perfection. Com C §9322(a)(1). "Filing" refers to the filing of an effective financing statement. Note that a financing statement can be filed for a security interest that has not yet "attached" under Com C §9203. Such as security interest becomes perfected if and when it does attach.

EXAMPLE: A borrower is bidding to buy the copyrights to several unregistered video game titles under development and wishes to arrange for debt financing ahead of the closing of the purchase. The borrower finds a lender (Lender A), enters into a loan agreement and authorizes Lender A to file a UCC-1 financing statement covering the catalogue before the borrower's purchase offer is accepted by the seller of the video games. Lender A makes the filing. The borrower then enters into an agreement to buy the video game titles and—without Lender A's knowledge—borrows more money from a second lender (Lender B). Lender B promptly files a UCC-1 financing statement also covering the video game catalogue. The borrower defaults on Lender A's loan, and Lender A seeks to foreclose on its security interest. Lender B objects, claiming that Lender B's security interest has priority over Lender A's. Lender A wins because its UCC-1 filing gave rise to a perfected security interest as soon as the borrower acquired rights in the collateral (see Com C §9203(b)(2)), i.e., when the borrower executed the purchase agreement (or alternatively, when the purchase transaction closed).

- As between two security interests when one is perfected and the other is not, the perfected security interest has priority. Com C §9322(a)(2).
- As between two security interests where neither is perfected, the first security interest to attach or become effective has priority. Com C §9322(a)(3).

NOTE: Commercial Code §9322's requirement that the security interest must always be perfected to maintain its priority can be a problem when the collateral includes unregistered copyrights. In the example above, assume that after purchasing the previously unregistered video game titles, the borrower registers them at the Copyright Office without telling Lender A. Lender B records its security interest at the Copyright Office. The borrower defaults on Lender A's loan, and Lender A seeks to foreclose on its security interest. Lender B objects, claiming that Lender B's security interest has priority over Lender A's. In this case, Lender B wins because Lender A's security interest became unperfected when the collateral was registered at the Copyright Office. See §9.54.

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b. Exceptions

§9.68 (1) Collateral Acquired by a Borrower Already Subject to a Security Interest

A security interest created by a borrower that would otherwise have priority under Com C §9322 will instead be subordinated to a security interest created by another person if (1) the borrower acquired the collateral already subject to the security interest created by the other person, (2) the security interest created by the other person was perfected when the borrower acquired the collateral, and (3) there is no period thereafter when the security interest is unperfected. Com C §9325.

EXAMPLE: Assume that, in the Example in §9.67, the company that sold the video game titles to the borrower granted Lender Z a security interest in them before the sale. Lender Z properly filed a UCC-1 financing statement covering the (then-unregistered) titles. The borrower-buyer does not register the copyrights in the video game titles and defaults on Lender A's loan. Lender A seeks to foreclose on its security interest. Lenders Z and B object, each claiming that its respective security interest has priority over Lender A's. Lender Z wins, because its perfected security interest traveled with the collateral and never became unperfected.

EXAMPLE: Assume that, in the immediately preceding Example, the borrower-buyer registers the copyrights in the video game titles without giving any of the lenders a chance to record their security interests at the Copyright Office. The borrower then defaults on Lender A's loan. Lender A seeks to foreclose on its security interest, but Lenders Z and B object, each claiming that its respective security interest has priority over Lender A's. In this case, Lender Z probably wins because none of the security interests are perfected, so the first to attach should prevail under Com C §9322(a)(3). Under the derivative title principle (see §9.73) and Com C §9201 (see §9.69), Lender A and Lender B each took their security interests subject to Lender Z's security interest.

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§9.69 (2) Bona Fide Licensee or Purchaser of Collateral Without Knowledge of Preexisting Security Interest

Commercial Code §9201 creates a general presumption that a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors. Commercial Code §9317(d), however, states that a licensee of a general intangible (or a buyer, other than a secured party, of accounts or general intangibles) takes free of a security interest if the licensee or purchaser gives value without knowledge of the security interest and before the security interest is perfected.

EXAMPLE: The borrower-buyer of the unregistered video game titles in the Examples in §§9.67-9.68 grants Distribution Company an exclusive license to distribute the titles through electronics retailers in exchange for valuable consideration. Distribution Company does not know of Lender A's security interest, and Lender A has not perfected its interest. The borrower-buyer defaults on Lender A's loan. Lender A seeks to foreclose and award all distribution rights to a third party. Distribution Company complains, claiming that any transferee must take subject to its license. Distribution Company wins, because under Com C §9317(d) Distribution Company took free of Lender A's unperfected security interest.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.70 (3) Nonexclusive Licensees of Collateral Already Subject to Preexisting Security Interest

§9.70 (3) Nonexclusive Licensees of Collateral Already Subject to Preexisting Security Interest

Under Com C §9321(b), a licensee in the ordinary course of business takes its rights under a nonexclusive license free of any security interest in the underlying intellectual property created by the licensor, even if the security interest was perfected and the licensee knew of its existence. In other words, the rights of an ordinary course nonexclusive licensee survive any exercise by the licensor's secured lender of its right to foreclose on a security interest in the licensor's underlying intellectual property.

NOTE: Commercial Code §9321(b) is set to expire in California on January 1, 2013, but will likely be extended, as it has been many times before. In all other states, this rule is permanent.

A "licensee in ordinary course of business" is defined as a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind. Com C §9321(a). A person becomes a licensee in the ordinary course if the license comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary practices. Com C §9321(a).

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§9.71 (4) Purchasers of Accounts

A purchaser of accounts (such as IP Licensing Revenue) that does not file a UCC-1 financing statement is also at risk of losing its rights in the accounts. If the purchaser fails to file a financing statement covering the accounts purchased, and the seller later grants a security interest or sells the same accounts again to someone else who does file a financing statement, then the subsequent purchaser will have priority over the earlier purchaser. See Com C §9322(a)(2).

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§9.72 2. Priority Rules Under Federal and State Intellectual Property Statutes

Assignments and certain other transfers of interests in patents, patent applications, registered copyrights, applications for copyright registration, federal- and state-registered trademarks, and applications for trademark registration are governed by the applicable federal or state statutes under which these intellectual property rights arise. The applicable statutes, and their effect on the priority of transferred interests, are discussed in context in §§9.74-9.96.

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§9.73 3. Common Law: Derivative Title Principle

Overarching both UCC Article 9 and the intellectual property statutes is the "derivative title" principle—the principle that a borrower cannot grant a security interest in (or sell or lease) property or rights that the borrower does not own. See *Bank of the West v Commercial Credit Fin. Servs., Inc.* (9th Cir 1988) 852 F2d 1162, 1174 (in general, a transferee's creditor can have no greater rights in collateral than the transferee had). Similarly, if the borrower's title is defective, the secured party inherits the defect. If the borrower's title is so defective that the borrower's title fails, UCC Article 9's priority rules concerning when (and to whom) a security interest has priority are not reached.

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B. Patents

§9.74 1. Applicable Law

As discussed in §9.44, the grant of a security interest in a patent (or a patent application) is not an "assignment, grant or conveyance" within §261 of the Patent Act. Therefore, the Patent Act does not preempt applicable state law (*i.e.,* UCC Article 9) concerning the granting or perfection of a security interest in a patent. *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, 1052, cert denied (2002) 534 US 1130.

Cybernetic Services also held that the Patent Act also does not preempt UCC Article 9 concerning the relative priority of competing security interests in the same patent—that perfection and priority are interrelated concepts. 252 F3d at 1044. Section 261 of the Patent Act only protects persons who take assignments or other transfers of *ownership interests* in a patent or patent application. It does not address the priority of a secured party who does not take title to the patent. Because the Patent Act does not control the issue, a security interest holder who complies with UCC Article 9's perfection requirements (see §9.45) will be protected, not only from subsequent secured parties of the patent holder, but also from subsequent assignees of the patent holder if that is the result under common law and UCC Article 9. See 252 F3d at 1053. This is consistent with the case law holding that only a legal title holder—as distinguished from the holder of equitable title, a license, or a security interest—can take advantage of the bona fide purchaser rule. See, *e.g., Rhone-Poulenc Agro, S.A. v DeKalb Genetics Corp.* (Fed Cir 2002) 284 F3d 1323, 1329, cert denied (2003) 539 US 957.

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§9.75 2. Prior Patent Assignment, License, or Mortgage Versus Subsequent, Perfected Patent Security Interest

Section 261 of the Patent Act (35 USC §261) gives priority to a person or entity who takes a patent assignment, grant, or conveyance and records its transfer document at the PTO within 3 months of the transfer date over a "subsequent purchaser or mortgagee for a valuable consideration without notice." See §9.44. Accordingly, a secured lender who takes a conditional patent assignment (see §§9.47-9.48), as a "subsequent purchaser or mortgagee" will have bona fide purchaser status under §261 and priority over a prior unrecorded patent assignment, license, or even possibly a mortgage. Because of the way §261 is worded, this is the outcome even if the lender does not record its conditional assignment at the PTO. If the secured lender does not record its conditional assignment at the PTO, however, the secured lender risks losing priority to a later bona fide purchaser who takes an assignment of the patent for valuable consideration without notice. See Ward, Intellectual Property in Commerce §2:98 (West Group 2009).

For a secured lender who takes only a security interest in the borrower's patent rather than a conditional assignment, the priority rules of UCC Article 9 (see §§9.67-9.71) and the common law derivative title principle (see §9.73) determine the outcome of a conflict between a prior assignment and the lender's security interest in the same patent collateral. See generally Com C §9322; §9.67. The derivative title principle determines the outcome of a conflict between a prior assignment or license and a subsequent mortgage, so that if the borrower parted with all of its rights in the prior transaction, the lender takes nothing. This should be the outcome regardless of whether the lender attempts to perfect its interest or whether the lender has actual knowledge of the prior transaction.

To lessen the risk that the borrower may have made a prior, conflicting assignment unknown to the lender, the lender might wish to delay funding the loan until 3 months after entering into its security agreement (see 35 USC §261) plus the period of the PTO database time lag (*e.g.*, another 3 months) and make funding contingent on the nonrecording of any conflicting assignment during the intervening 6-month period. As a practical matter, few lenders take this precaution. Instead, they rely on (1) the borrower's representation and warranty in the loan document that the borrower owns all right, title, and interest in and to the patents (and other IP Collateral), free and clear of liens, and (2) a contractual right not to fund the loan if this representation and warranty is false at the time of closing. If, after the lender funds, it becomes apparent that the representation and warranty was false (and was known by the borrower to be false when made), then the lender may have a fraud claim against the borrower. In no event, however, could the lender end up with a security interest in a patent if it turns out that the borrower did not own the patent to begin with.

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3. Prior, Perfected Patent Security Interest Versus Subsequent Patent Assignment, License, or Security Interest

§9.76 a. If Patent Collateral Is Subsequently Assigned

The effect of a patent assignment on an earlier perfected security interest in the same patent depends on whether the security interest was structured and documented as a conditional assignment or merely as a UCC Article 9 security interest under a conventional security agreement.

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§9.77 (1) And Prior Security Interest Structured as Outright or Conditional Assignment

Under 35 USC §261, a security interest structured as a conditional assignment (see §§9.47-9.48) and properly recorded at the PTO should not lose priority to a later assignment of the same patent.

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§9.78 (2) And Prior Security Interest Structured as UCC Article 9 Security Interest

The effect of a patent assignment on an earlier perfected security interest in the same patent if the prior security interest was structured and documented as a conventional UCC Article 9 security interest under a security agreement is not entirely clear. Under *Cybernetic Servs.,* the grant of a patent security interest that is not a transfer of title is not an "assignment, grant or conveyance," so the Patent Act should have no bearing and UCC Article 9 alone should control. See *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied (2002) 534 US 1130. Under Com C §9317(d), a licensee (or buyer) of a general intangible takes free of a security interest if the licensee (or buyer) gives value without knowledge of the security interest and before the security interest is perfected. Accordingly, under UCC Article 9, the subsequent patent assignment should have no effect on the earlier-perfected security interest.

It is not clear, however, that the Patent Act is entirely inapplicable to the issue. In *Cybernetic Servs.,* the lender's priority contest was with a bankruptcy trustee claiming that the lender was unperfected, but the court held that the lender was perfected. The case did not involve an unperfected lender in a contest with a subsequent bona fide purchaser. Unlike the bankruptcy trustee in *Cybernetic Servs.,* a subsequent bona fide purchaser would clearly qualify for the protections of §261 of the Patent Act (35 USC §261). Therefore, it is uncertain whether the *Cybernetic Servs*. holding means that a state-level UCC-1 financing statement filing is sufficient for a secured lender to defeat a bona fide purchaser of the same patent collateral for valuable consideration without notice of the prior security interest. Given this ambiguity, it would be prudent for the lender who obtains a security interest (rather than a conditional assignment) to record its security agreement at the PTO (within 3 months of signing) as well as filing the required UCC-1 financing statement, although doing so would not ensure that the lender obtains priority under 35 USC §261.

Cases dealing with other types of patent encumbrances support this recommendation. Courts have held that a purchaser of legal title to a patent without knowledge of a prior equitable encumbrance acquires title to the patent free of any prior equitable encumbrance. See, *e.g., Filmtec Corp. v Allied-Signal Inc*. (Fed Cir 1991) 939 F2d 1568, 1573. See also *V-Formation, Inc. v Benetton Group SpA* (D Colo, Mar. 10, 2006, No. 02-cv-02259-PSF-CBS) 2006 US Dist Lexis 13352. A borrower's assignment to a third party of the right to compel the borrower to assign the patent in the future is an example of an "equitable encumbrance." In contrast, a borrower's assignment of the patent itself would be effective to transfer legal title, not merely create an equitable encumbrance. Because a simple security agreement (in contrast to a conditional assignment) looks more like an equitable encumbrance, it appears more likely to be defeated by a subsequent bona fide purchaser without notice.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.79 b. If Patent Collateral Is Subsequently Licensed

§9.79 b. If Patent Collateral Is Subsequently Licensed

The effect of a subsequent license on an earlier security interest depends on whether the security interest was structured and documented as a conditional assignment or as a conventional UCC Article 9 security interest under a security agreement.

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§9.80 (1) And Security Interest Structured as Conditional or Outright Assignment

Under §261 of the Patent Act (35 USC §261) as well as the common law derivative title principle (see §9.73), a security interest structured as a conditional assignment (see §§9.47-9.48) and properly recorded at the PTO should have priority over a license purportedly given by the borrower in the same patent. Having assigned the patent to the lender, the borrower would have had nothing left to license, unless the conditional assignment from the borrower to the lender reserved this right.

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§9.81 (2) And Security Interest Structured as UCC Article 9 Security Interest

The effect of a later patent license on an earlier-perfected security interest that is structured and documented as a conventional UCC Article 9 security interest under a security agreement is less clear. Under patent common law, consistent with the derivative title principle (see §9.73), the assignee of a patent takes subject to whatever licenses or mortgages may already have been granted in that patent. *In re Cybernetic Servs., Inc*. (9th Cir 2001) 252 F3d 1039, 1052. See 6 Lipscomb, Walker on Patents §20:22 at 79; *V-Formation, Inc. v Benetton Group SpA* (D Colo, Mar. 10, 2006, No. 02-cv-02259-PSF-CBS) 2006 US Dist Lexis 13352 (BFP assignee of patents takes subject to assignor's prior settlement agreement); Ward, Intellectual Property in Commerce §2:97 (West Group 2009). As a result, the licensee would take subject to an earlier security interest, whether or not the earlier security interest was perfected.

UCC Article 9 appears to alter this outcome, however. Commercial Code §9317(d) states that a licensee (or buyer) of a general intangible takes free of a security interest if the licensee (or buyer) gives value without knowledge of the security interest and before the security interest is perfected. Commercial Code §9321 extends this result to subsequent licensees who gave value *with* knowledge of an earlier security interest, even if the prior security interest was perfected, if (1) the security interest was granted by the licensee's immediate licensor, and (2) the subsequent licensee was nonexclusive and "in the ordinary course." The secured lender must therefore perfect its security interest by filing a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a), to ensure that the security interest travels with the patent if the patent is later licensed without the secured lender's consent. If a secured lender authorizes the borrower to grant a license expressly or impliedly free of the security interest, the authorization extinguishes the security interest entirely. See Com C §9315(a)(1).

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c. If Second Security Interest Granted in Same Patent Collateral

§9.82 (1) If First Security Interest Structured as Conditional Assignment

If the first security interest is structured as a conditional or outright assignment (see §§9.47-9.48) and properly recorded at the PTO under 35 USC §261, the effect of a grant of a second security interest in the same patent depends on whether the second grant is also structured as a conditional assignment or as a conventional UCC Article 9 security interest under a security agreement.

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§9.83 (a) And Second Security Interest Structured as Conditional or Outright Assignment

If the second grant is also structured as a conditional assignment, §261 of the Patent Act (35 USC §261) should control. Under §261, the lender holding the first security interest has priority over the second, provided that the first secured lender recorded its assignment in the PTO within 3 months of execution. If the first secured lender did not do so, the second secured lender has priority over the first, provided that it took its security interest for valuable consideration without notice. Of course, the second secured lender can itself be displaced by a third secured lender if the second secured lender fails to record its assignment and the third takes its interest for valuable consideration without notice.

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§9.84 (b) And Second Security Interest Structured as UCC Article 9 Security Interest

If the second grant is structured as a conventional UCC Article 9 security interest under a security agreement, the result is less clear. If §261 of the Patent Act (35 USC §261) preempts UCC Article 9 (and in this case, it appears that it should), the first lender—the one holding an assignment properly recorded at the PTO—should have priority, regardless of whether the first lender filed a UCC-1 financing statement or whether the second lender made any filing. If §261 does not preempt UCC Article 9, then the first lender should have priority if it also filed a UCC-1 financing statement, because in substance the parties did intend to create a security interest. If §261 does not preempt UCC Article 9 and the first lender did not file a UCC-1 financing statement but the second lender did, then the second lender would have priority. See §§9.67-9.71.

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§9.85 (2) If First Security Interest Structured as UCC Article 9 Security Interest

If the first security interest was structured as a conventional UCC Article 9 security interest under a security agreement, the effect of a grant of a second security interest in the same patent should be controlled by common law and UCC Article 9 rather than §261 of the Patent Act (35 USC §261)—regardless of whether the second security interest is structured as a conditional assignment or as a conventional security interest. This result follows from the *Cybernetic Servs.* holding that security interests are not covered by §261. *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, 1052, cert denied (2002) 534 US 1130. Because §261 speaks only to the effect of a subsequent purchase or mortgage on an earlier "assignment, grant or conveyance," the grant of the first security interest is not an earlier transaction to which §261 would even apply.

Under patent common law, consistent with the derivative title principle (see §9.73), the assignee of a patent takes subject to any licenses or mortgages of that patent that have already been granted to third parties. *Cybernetic Servs.,* 252 F3d at 1052. If the second security interest is structured as a conditional assignment, the second lender would take its interest subject to the earlier security interest, whether or not the earlier security interest was perfected. If, however, the second security interest is structured under a conventional security agreement, only UCC Article 9 should apply and the first lender to file a UCC-1 financing statement should have priority. See §§9.67-9.71. The result is peculiar because the second lender—who took a lesser interest in the patent than the first lender, *i.e.,* a security interest rather than a conditional assignment—has a better chance of taking free of the earlier interest than the lender who obtained the conditional assignment. In any event, to avoid losing priority to a subsequent security interest in the same patent collateral, the earlier secured lender must perfect its interest by filing a UCC-1 financing statement at the borrower's location in accordance with Com C §§9307 and 9310(a).

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C. Copyrights

§9.86 1. Relevant Statutes

Section 205(a) of the Copyright Act (17 USC §205(a)) provides that either the signed original (or a certified copy of the signed original) of "[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office." Section 205(d) (17 USC 205(d)) provides:

> As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under [the Copyright Act] within one month after its execution in the United States or within two months after its execution outside the United States, or at any time before recordation… of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

For registered copyrights, recordation in the Copyright Office will give all persons constructive notice of the facts stated in the recorded document if (1) the document or material attached to it specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work, and (2) the work has been registered. 17 USC §205(c).

A nonexclusive copyright license, whether or not recorded, prevails over a conflicting transfer of copyright ownership if the license is evidenced by a written instrument signed by the owner of the licensed rights (or the owner's authorized agent), and if (1) the license was taken before execution of the transfer, or (2) the license was taken in good faith before recordation of the transfer and without notice of it. 17 USC §205(e).

In *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.*) (9th Cir 2002) 303 F3d 1120, the Ninth Circuit Court of Appeals held that the recordation and priority scheme of the Copyright Act (17 USC §§101-1332) controls perfection and priority of security interests in *registered* copyrights, and therefore preempts UCC Article 9 in that respect. See §9.52. On priority (and perfection) issues involving unregistered copyrights, however, UCC Article 9 controls. See §§9.53, 9.67-9.71. As in the case of patents, the derivative title principle also applies. See §9.73.

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2. Prior Copyright Assignment, License, or Mortgage Versus Subsequent, Perfected Copyright Security Interest

§9.87 a. If Collateral Is Registered Copyright

An assignment, exclusive license, or mortgage of a registered copyright that is recorded within the applicable 1- or 2-month look-back period of 17 USC §205(d) (or after the look-back period but before a later security agreement is recorded) will have priority over a later grant of a security interest, whether or not the later security agreement is ever recorded. See 17 USC §205(d). A nonexclusive license of a registered copyright, whether or not recorded, has priority over a later grant of a security interest, provided that the license was taken in good faith before recordation of the grant and without notice of it. 17 USC §205(e).

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§9.88 b. If Collateral Is Unregistered Copyright

Although the Copyright Act requires that all copyright assignments be in writing (17 USC §204(a)), there is no requirement that they be recorded at the Copyright Office and no mechanism for recording assignments of copyrights that are not themselves registered. See 17 USC §204. Accordingly, the common law derivative title principle (see §9.73) and UCC Article 9 (see §§9.67-9.71) determine priority between conflicting transfers and security interests in unregistered copyrights.

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3. Prior, Perfected Copyright Security Interest Versus Subsequent Copyright Assignment, License, or Mortgage

a. If Collateral Is Registered Copyright

§9.89 (1) And Copyright Is Subsequently Assigned

A subsequent assignee of a registered copyright that takes its assignment *from the borrower* for value and without notice of an earlier security interest will not have priority over the earlier security interest if the earlier security agreement was recorded either within the Copyright Act look-back period or after the look-back period but before the subsequent assignee records. See 17 USC §205(d). If the subsequent assignee has actual notice of the prior security interest, the subsequent assignee will not have priority over the earlier security interest, regardless of whether the secured lender recorded its interest. It is doubtful, however, whether a UCC-1 filing alone would be deemed to give the subsequent assignee notice.

If the borrower acquired the copyright from another party but failed to record the assignment, the result might be different. A second assignee of a registered copyright who takes its interest *from the original assignor* without notice, in good faith, and in a signed writing will have priority over a prior perfected security interest granted by the first assignee of the copyright if the first assignee (the borrower) took from the original assignor but failed to record its assignment. This is because under the Copyright Act, a subsequent recorded assignee of a registered copyright will defeat a prior unrecorded assignee of that copyright. See 17 USC §205(d). The fact that the prior unrecorded assignee granted a security interest that was recorded in between the two assignments does not change the result. The prior security interest loses priority along with the first unrecorded assignment, despite the fact that the security interest was perfected.

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§9.90 (2) And Copyright Is Subsequently Licensed

The effect of a subsequent license by the borrower on a prior, perfected security interest in a registered copyright depends on whether the license is exclusive or nonexclusive. If the license is exclusive, the outcome is the same as in the case of a subsequent assignment of a registered copyright. See §9.87. If the subsequent license is nonexclusive, the nonexclusive licensee has priority under 17 USC §205(e) if the license was in writing and was taken either (1) before the execution of the transfer of the security interest, or (2) in good faith before the security agreement was recorded.

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§9.91 (3) And Copyright Is Subsequently Mortgaged

A second secured lender who takes a security interest in a registered copyright *from the borrower* will lose priority to a prior perfected security interest in the same registered copyright if the first security interest was recorded either within the Copyright Act look-back period or after the look-back period but before the security agreement granting the second security interest is recorded. See 17 USC §205(d). If the second lender had actual notice of the prior security interest, which lender has priority is not as clear. Under the Copyright Act, the second secured lender would lose to the prior secured lender regardless of whether the prior secured lender ever records its security agreement. Under UCC Article 9, the secured lender who is first to perfect (by recording a security agreement at the Copyright Office) has priority over the other lender.

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b. If Collateral Is Unregistered Copyright

§9.92 (1) And Copyright Is Subsequently Assigned

Under UCC Article 9, a subsequent assignee of an unregistered copyright will lose priority to a prior, perfected security interest in the copyright, because the subsequent assignee cannot record its assignment at the Copyright Office if the copyright is not registered. See 17 USC §205(c); §9.53. The Copyright Act is inapplicable. If the copyright is later registered, however, and the subsequent assignee records its assignment before the secured lender can record its security agreement at the Copyright Office, then the subsequent assignee will have priority over the prior, perfected security interest because the security interest became unperfected when the underlying copyright was registered. See §9.54. This illustrates why it is important for the lender to prohibit the borrower from registering any previously unregistered copyrights included in the collateral without the lender's consent and without giving the lender an opportunity to make contemporaneous filings accompanying the registration.

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§9.93 (2) And Copyright Is Subsequently Licensed

The effect of a subsequent license by the borrower on a prior, perfected security interest in an unregistered copyright depends on whether the license is exclusive or nonexclusive. If it is exclusive, the outcome is the same as in the case of a subsequent assignment of an unregistered copyright. See §9.92. If it is nonexclusive, under Com C §9321(b), a licensee in the ordinary course of business takes its rights free of a prior, perfected security interest created by the licensor in the licensed copyright, even if the licensee knew of the existence of the security interest. As a consequence, the rights of a licensor's ordinary course nonexclusive licensee will survive any foreclosure by the licensor's secured lender on the licensed copyright. Under the Copyright Act, a nonexclusive licensee has priority over a conflicting security interest if the licensee's license was in writing and entered into before the grant of the security interest was executed or before the security interest was recorded. See 17 USC §205(e).

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D. Federally Registered Trademarks

§9.94 1. Relevant Statutes

Regarding federally registered trademarks (and applications for trademark registration), §10(a)(4) of the Lanham Act (15 USC §1060(a)(4)) provides that "[a]n assignment shall be void against any subsequent purchaser for valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the [PTO] within 3 months after the date of the assignment or prior to the subsequent purchase." See also §9.57. A secured lender who takes a security interest in a trademark is not a "purchaser" within this statute, so the Lanham Act is not applicable in analyzing the priority of a prior assignment, license, or mortgage of a trademark in relation to a subsequent grant of a security interest in the same mark. *Joseph v 1200 Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778, 782.

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§9.95 2. Prior Trademark Assignment, License, or Security Interest Versus Subsequent Perfected Trademark Security Interest

The analysis of the priority of a prior trademark assignment, license, or security interest in relation to a subsequent perfected trademark security interest is similar to the analysis of the priority of a prior patent assignment, license, or security interest in relation to a subsequent perfected patent security interest (see §9.75), except that §10(a)(4) of the Lanham Act (15 USC §1060(a)(4))—unlike §261 of the Patent Act (35 USC §261)—does not include the word "mortgagee."

Although a trademark assignment would be subject to §10(a)(4) of the Lanham Act, a lender should not take either an outright or a conditional trademark assignment from the borrower, in order to avoid the risk that the assignment would constitute an "assignment in gross" that, if challenged, could invalidate the mark. See §9.57.

If the lender takes a security interest in the borrower's trademark, the priority rules of UCC Article 9 (see §§9.67-9.71) and the common law derivative title principle (see §9.73) determine the outcome of a conflict between a prior trademark assignment, license, or security interest and the lender's security interest in the same trademark collateral. See generally Com C §9322; §9.67. The derivative title principle controls the outcome of a conflict between a prior assignment or license and a subsequent security interest, so that if the borrower parted with all of its rights in the prior transaction, the lender would take nothing.

To lessen the risk that the borrower may have made a prior, conflicting assignment unknown to the lender, the lender might wish to delay funding the loan until 3 months after entering into its security agreement (see 15 USC §1060) plus the period of the PTO database time lag (*e.g.,* another 3 months) and make funding contingent on the nonrecording of any conflicting assignment during the intervening 6-month period. See §9.75.

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§9.96 3. Prior, Perfected Trademark Security Interest Versus Subsequent Assignment, License, or Security Interest

The effect of a subsequent assignment, license, or security agreement on a prior perfected trademark security agreement is essentially the same as in the case of a prior perfected patent security agreement. See §§9.76-9.78. As in cases involving patent collateral, to lessen the risk that a subsequent bona fide purchaser will take an assignment of the trademark and thereafter assert a superior claim, a lender obtaining a perfected security interest in a federally registered trademark should consider also recording its security agreement at the PTO. See §9.78. The lender will be subject to the same risks concerning the 3-month look-back period in 15 USC §1060(a)(4) and lag time for its recording to appear in the PTO database that the lender faces in the case of patents.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.97 E. Table Summarizing Bona Fide Purchaser Risk

§9.97 E. Table Summarizing Bona Fide Purchaser Risk

The following table summarizes the bona fide purchaser risk a secured lender faces with the various forms of registered IP Collateral.

COLLATERAL	BONA FIDE PURCHASER RISK
Patents (when security agreement rather than assignment is used) 35 USC §261	3 months plus database lag time
Copyrights—Registered 17 USC §205(d)	1-2 months plus database lag time
Copyrights—Unregistered	None if work remains unregistered
Trademarks—Federally Registered 15 USC §1060(a)	3 months plus database lag time
Trademarks—State Registered Bus & P C §14220	3 months plus database lag time
Trademarks—Unregistered	None
Trade Secrets	None

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§9.98 VI. DEALING WITH CHANGES AFTER SECURITY AGREEMENT BECOMES EFFECTIVE

The most common forms of secured lending transactions are (1) term loans for fixed sums of money repayable in installments with a predetermined maturity date, and (2) revolving loans or lines of credit that can be borrowed, paid back, and reborrowed over an extended period of time. With both forms of loans, the borrower and lender are involved in a transaction that endures for months or even years. The covenants in the loan agreement or security agreement circumscribe what the borrower can and cannot do during the life of the loan, while recognizing that there will be changes in the borrower's business and collateral over the life of the loan. Most changes will be in the ordinary course of the borrower's business, but some might not. When IP Collateral is involved, the effect that changes can have on the lender's position depends on the nature of the change and type of IP Collateral at issue. Sections 9.99-9.129 describe some of the more common changes that may need to be addressed and suggest ways for borrower's and lender's counsel to anticipate them in the original loan documents.

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§9.99 A. Additions to IP Collateral

A borrower whose business involves creating or acquiring, and exploiting or licensing out, assets included in IP Collateral will most likely add to the body of its IP Collateral over the life of the loan. The secured lender needs to know that the new IP Collateral will be covered by its security interest, that its security interest in the new collateral will be perfected, and that the security interest in the new collateral will, like the old collateral, have priority over the interests of third parties. In essence, the lender wants a "floating lien" on the IP Collateral—a lien that expands to cover new IP assets as they are added to the borrower's business.

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§9.100 1. Applicable Provisions of UCC Article 9

UCC Article 9 facilitates such "floating liens" through a series of provisions. Official Comment 2 to UCC §9-204(a) provides that except in the case of commercial tort claims or consumer goods, a security agreement may create or provide for a security interest in after-acquired collateral. Com C §9204(a). Nearly all security agreements therefore either (1) include a clause that either grants the lender a security interest in property acquired by the borrower after the security agreement becomes effective or (2) include after-acquired property in the definition of the collateral subject to the security interest.

In general, as discussed in §§9.21-9.35, for a security interest to be enforceable under UCC Article 9 it must "attach." See Com C §9203. A security interest cannot attach unless the borrower has "rights in" the property covered by the security interest. Com C §9203(b)(2). What constitutes "rights in" after-acquired IP Collateral for purposes of marking the moment of attachment is unclear. As a general rule, a borrower can have no rights in collateral that does not exist. Therefore, even though under §9204(a) a security agreement can "create" a security interest in after-acquired property, the security interest will not be enforceable until the collateral exists and can attach under Com C §9203.

UCC Article 9 creates an important statutory exception to this general rule. A lender can acquire a presently enforceable security interest in future *proceeds* of existing collateral, even though the proceeds have not yet been generated. See Com C §9315. Much therefore rests on how the term "proceeds" is defined. In *Orton v Virtual Fonlink, Inc*. (Nov. 18, 2004, G032862; not certified for publication) 2004 Cal App Unpub Lexis 10566, the court held that a patent is considered the proceeds of a patent application. Although UCC Article 9 governs what constitutes "proceeds," if the collateral includes registered patents, trademarks, or copyrights, the federal intellectual property laws also bear on the issue of when the property comes into existence and whether the property qualifies as "proceeds."

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2. Adding Patent Collateral

§9.101 a. After-Acquired Patents and Patent Applications

A borrower can acquire more patents and patent applications after a security agreement becomes effective in a number of ways. The borrower might come up with a new and patentable invention and apply for a patent. The borrower might purchase a patent or patent application outright from a third party. A patent may issue from a patent application filed earlier, as in *Orton v Virtual Fonlink, Inc.* (Nov. 18, 2004, G032862; not certified for publication) 2004 Cal App Unpub Lexis 10566.

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§9.102 (1) Creation

It can be difficult to fix exactly when a borrower acquires "rights in" a new patent or new patent application for purposes of Com C §9203(b)(2). Take for example the common situation where a company acquires a patent based on an invention by one of its employees. A patent application can only be filed by the actual inventor or inventors. See 35 USC §111(a)(1). The application can be assigned by an inventor to the inventor's employer or some other third party after, but not before, it is filed. See 35 USC §261. Does the employer have enough "rights in" the application for a security interest in the patent application to attach before the application is filed? The answer appears to be "yes," *if* the inventor is contractually obligated to assign the application to the employer. See Ward, Intellectual Property in Commerce §2.24 (West Group 2009).

What about the situation where a borrower acquires legal title to a patent but fails to record the transfer with the PTO? Section 261 of the Patent Act (35 USC §261) gives bona fide purchasers of patents and patent applications who take their interests without notice for value priority over earlier, unrecorded assignments. Does a borrower who acquired the patent, but failed to record the assignment, still have "rights in" the patent? Under §261, the answer appears to be "yes," unless and until the borrower is trumped by a subsequent bona fide purchaser who takes without notice for value.

For the secured lender, this means that it may be difficult to know exactly if and when a borrower's after-acquired patent or patent application becomes part of the collateral package. The lender should conduct its own careful investigation before extending additional credit or altering the loan terms based on newly acquired patents or patent applications. To lessen the risk that a third party might claim that an earlier UCC-1 filing does not cover a subsequently issued patent or filed patent application, the secured lender should make a subsequent filing at the PTO to ensure that its previously granted security interest in the after-acquired patent collateral is a matter of record at the PTO. Preferably, the lender should require the borrower to enter into a conditional assignment of the patent to the lender, or otherwise a patent security agreement. See generally §§9.46-9.48.

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§9.103 (2) Perfection

Once the lender knows that the borrower has added a valuable patent or patent application to the collateral, how can the lender be assured that its security interest will be perfected and have the same priority as the original collateral? As discussed in §9.44, UCC Article 9 alone governs perfection and priority in a patent or patent application. Under UCC Article 9, the borrower's original UCC-1 filing should cover the after-acquired patent in which a security interest is created and automatically perfected. See Com C §9204(a). As noted in §9.102, however, the lender should also record a conditional assignment of the newly acquired patent or patent application (or, in the alternative, a supplemental patent security agreement) with the PTO.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.104 b. After-Acquired Inbound Patent Licenses and Licensed Rights

§9.104 b. After-Acquired Inbound Patent Licenses and Licensed Rights

The borrower might enter into new inbound patent licenses after the effective date of its security agreement. If these licenses have significant value on a stand-alone basis or are material to the conduct of the borrower's business, the lender will want an enforceable, perfected, first priority security interest in them.

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§9.105 (1) Creation

As in the case of an after-acquired patent or patent application, if the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in the new licenses as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2). The borrower acquires "rights in" the licenses when the license agreements become effective.

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§9.106 (2) Perfection

Under Com C §9204(a), the lender's security interest in newly entered into or acquired inbound licenses will be automatically perfected under the original UCC-1 financing statement filing. The Patent Act is not relevant to the analysis. See §9.49.

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§9.107 c. After-Acquired Rights to Patent Royalties and Receivables

After-acquired rights to patent royalties and receivables can arise in a variety of ways. For example, the borrower-licensor might enter into outbound patent licenses after its security agreement becomes effective. Rights to patent royalties and receivables can also arise under outbound licenses that predate the security agreement on account of sales of products incorporating the patent that occur after the security agreement becomes effective.

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§9.108 (1) Creation

If the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in the rights to patent royalties and receivables arising after the security agreement becomes effective as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2). The borrower typically acquires "rights in" patent royalties and receivables when the borrower-licensor's licensee becomes contractually obligated to pay them.

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§9.109 (2) Perfection

Under Com C §9204(a), the lender's security interest in after-acquired patent royalties and receivables will be automatically perfected under the original UCC-1 financing statement filing. The Patent Act is not relevant to the analysis. See §9.50.

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3. Adding Copyright Collateral

a. After-Acquired Registered Copyrights and Applications for Copyright Registrations

§9.110 (1) Creation

If the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in after-acquired registered copyrights and applications for copyright registrations as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2).

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§9.111 (2) Perfection

As discussed in §9.52, perfection of security interests in registered copyrights is governed solely by the Copyright Act and does require a filing at the Copyright Office. For a Copyright Office filing to be effective for purposes of giving third parties constructive notice of its contents, the filing must specifically identify the work in question so that a search by title or registration number will reveal its existence. 17 USC §205(c)(1). Accordingly, for after-acquired registered copyrights, the lender must make a subsequent filing at the Copyright Office so that its security interest in an after-acquired copyright will be perfected. This subsequent filing may take the form of a supplemental copyright security agreement, similar to the form in App D-3.

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b. After-Acquired Unregistered Copyrights

§9.112 (1) Creation

If the security agreement contains an "after-acquired" clause, the lender will automatically have a security interest in after-acquired unregistered copyrights as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2).

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§9.113 (2) Perfection

As discussed in §9.53, perfection of security interests in unregistered copyrights is governed solely by UCC Article 9, and requires only the filing of a UCC-1 financing statement with the Secretary of State. Accordingly, the after-acquired property rules of UCC Article 9 (see Com C §9204(a)) apply to unregistered copyrights that the borrower creates or acquires after the security agreement becomes effective, and no additional filing beyond the original UCC-1 financing statement is required to perfect a security interest in after-acquired unregistered copyrights. If, however, an after-acquired unregistered copyright is subsequently registered, the lender's security interest will become unperfected unless and until a filing is made with the Copyright Office. See §9.54. The lender should therefore prohibit the borrower from registering previously unregistered copyrights without first obtaining the lender's consent and affording the lender the opportunity to coordinate an accompanying recordation of its security interest, both in the registration application and in the registered copyright after the registration issues.

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§9.114 c. After-Acquired Inbound Copyright Licenses

How a security interest in an after-acquired inbound copyright license is created is clear (see §9.115), but how such a security interest is perfected appears to depend on whether the copyright license is exclusive or nonexclusive and on whether the underlying copyright is registered or unregistered. See §§9.116-9.117.

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Source: Business Law/Intellectual Property in Business Transactions/9 Intellectual Property in Secured Lending Transactions/§9.115 (1) Creation

§9.115 (1) Creation

If the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in an after-acquired exclusive or nonexclusive inbound copyright license as soon as the borrower acquires "rights in" it for purposes of Com C §9203(b)(2). The borrower acquires "rights in" any inbound copyright license when the license agreement becomes effective.

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§9.116 (2) After-Acquired Exclusive Inbound Copyright Licenses: Perfection

An exclusive copyright license is a transfer of an interest in a copyright. See the definition of "transfer" in 17 USC §101. Accordingly, when an exclusive inbound license of a *registered* copyright is added to the collateral, the lender should make a subsequent filing in the Copyright Office, specifically identifying the underlying registered work (see 17 USC §205(c)(1)), just as the lender would be required to do if its security interest were in the underlying copyrighted work. See §§9.52, 9.111. If, however, the newly acquired exclusive inbound license is of an *unregistered* copyright, the lender need not make any additional filing at the Copyright Office. See §§9.53, 9.113. Under Com C §9204(a), the original UCC-1 financing statement filing should be adequate to perfect the lender's security interest in the borrower's after-acquired exclusive licenses, whether the licenses cover registered or unregistered copyrights.

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§9.117 (3) After-Acquired Nonexclusive Inbound Copyright Licenses: Perfection

Unlike an exclusive copyright license, a nonexclusive copyright license is not a transfer of an interest in copyright. See the definition of "transfer" in 17 USC §101. Accordingly, the Copyright Act should be irrelevant to the question of perfection of a security interest in an after-acquired nonexclusive copyright license, and this should be so regardless of whether the underlying copyrights are registered or unregistered. Accordingly, when the borrower acquires a nonexclusive inbound copyright license after entering into a secured loan, the lender's security interest in the license should be perfected under Com C §9204(a) by operation of its original UCC-1 financing statement filing.

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§9.118 d. After-Acquired Rights to Copyright Royalties and Receivables

Like after-acquired rights to patent royalties (see §9.107), after-acquired rights to copyrights royalties and receivables can arise in a variety of ways. For example, the borrower-licensor might enter into an outbound copyright license after its security agreement becomes effective. Rights to copyright royalties and receivables can also arise under an outbound license that predates the security agreement on account of sales of products incorporating the copyrighted work that occur after the security agreement became effective.

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§9.119 (1) Creation

Also like after-acquired rights to patent royalties (see §9.108), if the security agreement contains an "after-acquired" property clause, the lender will automatically have security interest in royalties and receivables arising after the security agreement becomes effective, as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2). The borrower typically acquires "rights in" royalties and receivables when the borrower-licensor's licensee becomes contractually obligated to pay them.

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§9.120 (2) Perfection

In theory, a lender's security interest in after-acquired IP Licensing Revenue from outbound licenses (which are "accounts" under UCC Article 9; see §9.34) should be automatically perfected based on the original UCC-1 financing statement filing under Com C §9204(a), and no federal-level filing should be necessary. As discussed in §9.56, however, in the case of copyright royalties (and other copyright receivables), existing precedent differs on whether a Copyright Office filing is required for perfection. The court in *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194 held that a security interest in receivables generated by a copyrighted work can only be perfected by a filing in the Copyright Office. It is likely, however, that the *Peregrine* holding was limited by implication in *Aerocon Eng'g Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120, 1130, to royalties and receivables derived from *registered* copyrights, not *unregistered* copyrights. See §9.56.

In view of the uncertainty over the issue of whether the Copyright Act preempts UCC Article 9 concerning perfection of a security interest in copyright receivables, a lender with a security interest in after-acquired receivables from registered copyrights should consider recording supplemental security agreements at the Copyright Office as new outbound licenses covering registered copyrights are entered into by the borrower. To the extent that the after-acquired receivables arise from unregistered copyrights, the original UCC-1 financing statement will automatically perfect the lender's interest in such receivables.

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4. Adding Trademark Collateral

a. After-Acquired Trademarks

§9.121 (1) Creation

If the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in after-acquired trademarks as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2).

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§9.122 (2) Perfection

As discussed in §9.57, perfection of security interests in trademarks—even federally registered trademarks—is governed solely by UCC Article 9, and requires only the filing of a UCC-1 financing statement with the Secretary of State. Accordingly, UCC Article 9's after-acquired property provision (Com C §9204(a)) applies to trademarks that the borrower creates or acquires after the security agreement becomes effective. No filing beyond the original UCC-1 financing statement is required to perfect a security interest in an after-acquired trademark.

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§9.123 b. After-Acquired Inbound Trademark Licenses and Licensed Rights

The borrower might enter into new inbound trademark licenses after the effective date of its security agreement. If these licenses have significant value on a stand-alone basis or are material to the conduct of the borrower's business, the lender will want an enforceable, perfected, first priority security interest in them.

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§9.124 (1) Creation

As in the case of an after-acquired trademark (see §9.121), if the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in the new inbound trademark licenses as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2). The borrower acquires "rights in" the licenses when the license agreements become effective.

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§9.125 (2) Perfection

Under Com C §9204(a), the lender's security interest in newly entered into or acquired inbound trademark licenses will be automatically perfected under the original UCC-1 financing statement filing. The Lanham Act is not relevant to the analysis. See §9.60.

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§9.126 c. After-Acquired Rights to Trademark Royalties and Receivables

Like after-acquired patent and copyright royalties (see §§9.107, 9.118), after-acquired rights to trademark royalties and receivables can arise in a variety of ways. For example, the borrower-licensor might enter into outbound trademark licenses after its security agreement becomes effective. Rights to trademark royalties and receivables can also arise under an outbound trademark license that predates the security agreement on account of exploitation of the mark that occurs after the security agreement becomes effective.

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§9.127 (1) Creation

Also like after-acquired rights to patent and copyright royalties (see §§9.108, 9.119), if the security agreement contains an "after-acquired" property clause, the lender will automatically have a security interest in trademark royalties and receivables that arise after the security agreement becomes effective, as soon as the borrower acquires "rights in" them for purposes of Com C §9203(b)(2). The borrower typically acquires "rights in" royalties and receivables when the borrower-licensor's licensee becomes contractually obligated to pay them.

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§9.128 (2) Perfection

Under Com C §9204(a), the lender's security interest in after-acquired trademark royalties and receivables will be automatically perfected under the original UCC-1 financing statement filing. The Lanham Act is not relevant to the analysis. See §9.61.

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§9.129 B. Deletions From IP Collateral

If the secured lender agrees to release its security interest in some of the borrower's IP Collateral before the loan is fully repaid, *e.g.,* to facilitate a sale or license by the borrower of that part of the IP Collateral free and clear of the lender's interest, the question arises how to accomplish the release without jeopardizing the lender's priority in the remaining IP Collateral.

If a UCC-1 financing statement was filed to perfect the security interest, the financing statement remains effective for 5 years after filing. Com C §9515. A secured party may file a termination statement under Com C §9513 stating that its security interest has terminated, but the original UCC-1 financing statement remains on the records of the Secretary of State. Therefore, the secure party's security interest should continue to be perfected, with its original priority, in any IP Collateral not released.

A secured party may file a UCC-3 financing statement amendment under Com C §§9512 and 9515 to continue the effectiveness of its financing statement for an additional 5 years, to terminate its financing statement, to evidence an assignment of its financing statement, or to add or delete collateral. The borrower's physical signature on the UCC-3 amendment is not required, but the amendment can be filed only if the borrower has authorized the filing in an authenticated record or a security agreement or has acquired collateral in which a security agreement continues. Com C §9509(a)-(c). Any person who knowingly procures or offers any false or forged financing statement for filing at the California Secretary of State is guilty of a felony under Pen C §115. *People v Gruber* (Sept. 22, 2006, F047525; not certified for publication) 2006 Cal App Unpub Lexis 8448 (holding that "knowingly" means with actual knowledge of the false or forged nature of the instrument; reckless acts are not enough).

If a patent, trademark, or copyright security agreement was filed at the PTO or Copyright Office (as applicable), it will be necessary for the secured party to file a full or partial release of the earlier security agreement. If a conditional assignment was filed, it will be necessary for the secured party to enter into an assignment of the relevant IP Collateral back to the borrower and file the assignment at the applicable office.

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§9.130 VII. EXERCISING REMEDIES AGAINST IP COLLATERAL

Having a valid and perfected security interest in IP Collateral is only as good as the secured lender's ability to realize on the value of its collateral in the event of a default. The remedies that a secured lender has, and the procedures for enforcing them, are governed by state law and, if state law permits the parties to alter the result otherwise provided by state law, the contracts between the lender and borrower. See *Republic Pictures Corp. v Security-First Nat'l Bank of Los Angeles* (9th Cir 1952) 197 F2d 767, 769. See also Com C §9601(a). Importantly, a lender who takes and records at the PTO a conditional assignment of a patent or patent application (see §§9.46-9.48) as security will still be subject to UCC Article 9 when it comes time to exercise remedies if the borrower defaults—because UCC Article 9 applies to transactions that are intended to function as security regardless of their title or form. See Com C §9109(a)(1); *Warnaco, Inc. v Farkas* (2d Cir 1989) 872 F2d 539, 543 (trademark license under which title passes on satisfaction of debt treated as security agreement); Ward, Intellectual Property in Commerce §3:6 (West Group 2009).

If the borrower defaults on a loan secured with IP Collateral, the secured lender has the remedies provided in UCC Article 9 together with any other rights provided by agreement of the parties. Com C §9601(a)(1). For example, a lender whose borrower defaults on a loan secured with patent assets can sue the borrower, obtain a judgment, and obtain a court order directing the patent holder to assign the patent to the lender or its nominee. The patent holder need not personally execute an assignment; the court may authorize a court officer to execute the assignment, which is then binding on the patentee. See *Constant v Advanced Micro-Devices* (9th Cir, Dec. 3, 1993, Nos. 92-55465, 92-56220, 92-56475; disposition not appropriate for publication) 1993 US App Lexis 31939.

Exercising remedies involves not merely understanding what they are, but knowing how, as a practical matter, to enforce them. The remedies available to a secured lender under UCC Article 9 are discussed in §§9.132-9.157. Any potential remedies available outside UCC Article 9 are beyond the scope of this discussion. This section also proceeds on the assumption that the borrower has not yet voluntarily or involuntarily entered bankruptcy despite causing an event of default that allows the secured lender to exercise its remedies. If a borrower enters bankruptcy, the secured lender's ability to exercise its remedies will be limited by the "automatic stay" imposed by the bankruptcy filing, and any recourse by the secured lender will likely have to be conducted under the auspices of the bankruptcy court, a subject that is beyond the scope of this chapter.

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§9.131 A. Applicable Provisions of UCC Article 9

The state law governing a secured lender's postdefault remedies is found mainly in Part 6 of UCC Article 9 (Com C §§9601-9629). These sections are generally intended to protect the borrower against involuntary forfeiture of its ownership equity in collateral. In contrast, the lender's goal is to recover as much of its debt as possible, as quickly as possible, in the least costly way. Without UCC Article 9's borrower protections, the lender might not be motivated to maximize the value of the collateral beyond the amount of the debt owed. Accordingly, many of UCC Article 9's borrower-friendly provisions cannot be waived in advance of a default, *i.e.,* they cannot be contracted away in the original loan or security agreement at the time of its execution. See Com C §9602.

The most important protections that a borrower cannot waive before default are (1) the secured lender's obligation to dispose of the collateral in a "commercially reasonable manner" (see Com C §9610(b)) and properly account for the proceeds (see Com C §9615); (2) the borrower's right to have the collateral retained in satisfaction of the debt in compliance with Com C §§9620-9622; and (3) when the collateral consists of receivables (*e.g.,* IP Licensing Revenue), the secured party's obligation to have the receivables collected in a commercially reasonable manner and (when appropriate) to have any surplus properly determined and turned over to the borrower (see Com C §9607). See generally Com C §9602; Official Comment 3 to UCC §9-602. Certain borrower rights can be waived after default, however, under Com C §9624.

The job of lender's counsel is therefore to draft agreements that are as lender-friendly as possible yet do not go so far as to be unenforceable. Importantly, Com C §9603 allows the borrower and lender to agree in advance what standards will be applied to measure the commercial reasonableness of a disposition of the collateral, as long as the standards are not "manifestly unreasonable."

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§9.132 B. Stage 1: Declaring Event of Default

Article Nine breaks the process a lender follows to exercise its remedies against a security interest into three sequential stages: default, control, and realization.

In the first stage, there is a breach of the borrower's obligations or some adverse outside event occurs that results in an "event of default" under the loan and security agreement. On the borrower's default, a secured party has the rights provided in Article 9 and, to the extent that Article 9 permits the parties to contract differently, the rights set forth by agreement of the parties. Com C §9601(a). What constitutes "default" is purely a matter of the parties' agreement.

An "event of default" can be something that is triggered automatically without any additional action by the lender or it can be something that the lender considers so threatening to the borrower's ability to repay its debt as to cause the lender to declare an event of default. Either way, the event of default is something that either threatens the borrower's ability to repay its debt or perform its secured obligations or that imperils the value of the collateral.

Where IP Collateral is involved, the parties' agreement must be specifically tailored to cover the types of things that can happen to IP Collateral and should give the lender the right to start the process of foreclosure. Occurrences that would entitle a lender to declare an event of default where IP Collateral is concerned might include the sample defaults set forth in §§9.133-9.138.

This is not to say that the lender will necessarily declare an event of default with each adverse occurrence. The point is that the lender should have the right to commence the foreclosure process if it chooses to do so. The parties can waive and modify default terms by their course of conduct.

The security agreement must state that on an event of default the borrower's obligations on the underlying debt are accelerated. Absent an acceleration clause, the lender can only realize on the collateral to the extent of the missed installment payment. The security agreement should also state that on an event of default the lender can access the collateral.

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§9.133 1. Form: Sample Defaults Related to Patent Collateral

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9.133-1 Sample defaults related to patent collateral

(1) The borrower's failure to prosecute a patent application that is material to the conduct of the borrower's business.

(2) Failure of an individual employee inventor to assign a material patent application to the borrower.

(3) Determination by the PTO or a court that a patent which is material to the conduct of the borrower's business is invalid or unenforceable.

(4) Administrative or judicial determination that a particular aspect of the borrower's services or goods that is believed to be patent-protected is, in fact, not patent-protected.

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§9.134 2. Form: Sample Defaults Related to Copyright Collateral

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9.134-1 Sample defaults related to copyright collateral

(1) The filing by the borrower of an application for a copyright registration without the lender's prior written consent.

(2) In the case of unregistered copyrighted works that are exclusively licensed to the borrower and material to its business, the application for registration by the licensor of the works in circumstances where the secured lender's security interest may become unperfected.

(3) Failure of an author to assign to the borrower works of authorship created on behalf of the borrower.

(4) Failure of an employee to execute a work-made-for-hire agreement as to works of authorship created by such employee which are material to the borrower's business.

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§9.135 3. Form: Sample Defaults Related to Trademark Collateral

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9.135-1 Sample defaults related to trademark collateral

(1) Any act or omission by the borrower that threatens to invalidate or result in the abandonment of the trademark.

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§9.136 4. Form: Sample Defaults Related to Trade Secrets Collateral

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9.136-1 Sample defaults related to trade secrets collateral

(1) Any failure by the borrower to take steps required to preserve the trade secret status of its trade secrets.

(2) The disclosure of a trade secret that is material to the conduct of the borrower's business.

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§9.137 5. Form: Sample Defaults Related to Inbound License Collateral

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9.137-1 Sample defaults related to inbound license collateral

(1) The receipt of notice of breach, default, termination or nonrenewal of an Inbound License that is material to the borrower's business.

(2) The borrower's failure to meet milestones set forth in any Inbound License that is material to the borrower's business.

(3) The expiration, termination, or nonrenewal of an Inbound License that is material to the borrower's business.

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§9.138 6. Form: Sample Defaults Related to Receivables From Outbound IP Licenses

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9.138-1 Sample defaults related to receivables from outbound IP licenses

(1) The failure of a license or sublicense to pay royalties or licensing fees where the failure could reasonably be expected to have a material adverse effect on the borrower's business.

(2) The expiration, termination or nonrenewal of an Outbound License that is material to the borrower's business.

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§9.139 C. Stage 2: Getting Control of the Collateral

Before a secured lender can, as a practical matter, take steps to realize the value of its collateral, the lender must possess or otherwise take control of the collateral. This is different from, and a precursor to, foreclosing on the collateral. UCC Article 9 contemplates that in some cases the secured lender will already have possession of the collateral, thereby obviating any need to gain control. Because IP Collateral (apart from the media in which it is embodied) cannot be "possessed," the question faced by the secured lender is what is "control" of IP Collateral and how can the lender go about obtaining control?

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§9.140 1. Physical Embodiments of IP Collateral: DVDs, Books, Disks

UCC Article 9 entitles a secured lender to take possession of physical embodiments of IP Collateral, such as DVDs, books, compact disks, and the like, if the secured lender can do so without a "breach of the peace." See Com C §9609. See also Official Comment 3 to UCC §9-609. UCC Article 9 does not explain what constitutes a breach of the peace. Courts have held that a secured lender cannot normally enter the borrower's premises—where inventory or other embodiments of the IP Collateral are generally located—without the borrower's consent. See *Boudreau v Borg-Warner Acceptance Corp*. (9th Cir 1980) 616 F2d 1077.

When the lender does take possession of physical goods embodying IP Collateral, certain provisions of Com C §9207 are relevant. The secured party is required to use reasonable care in the custody and preservation of collateral in the secured party's possession. Com C §9207(a). If the secured party has possession of collateral: (1) reasonable expenses, including the cost of insurance and payment of taxes or other charges, incurred in the custody, preservation, use, or operation of the collateral are chargeable to the borrower and are secured by the collateral; (2) the risk of accidental loss or damage is on the borrower to the extent of a deficiency in any effective insurance coverage; (3) the secured party is required to keep the collateral identifiable, but fungible collateral may be commingled; and (4) the secured party may use or operate the collateral: (a) for the purpose of preserving the collateral or its value; (b) as permitted by court order; and (c) except in the case of consumer goods, in the manner and to the extent agreed by the borrower. Com C §9207(b).

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§9.141 2. Intangible Rights in IP Collateral

The bigger challenge for the secured lender whose collateral includes IP Rights will be how to get control so that the lender can foreclose on it and prevent the borrower from using the IP Collateral in the meantime. If registered IP Collateral is involved, the secured lender will likely need to record at least a temporary record of ownership in order to be able to dispose of it. Commercial Code §9619 gives the secured lender a mechanism for achieving this, through use of a transfer statement. See §9.47. For a sample form of transfer statement, see App D-9.

If the security agreement permits, §9619 authorizes the secured lender to authenticate unilaterally a transfer statement to enable a later transfer of record title from the borrower to a third party or even to the secured lender itself. See Ward, Intellectual Property in Commerce §3:26 (West Group 2009). To be effective, the statement must be authenticated and state that: (1) the borrower has defaulted in connection with an obligation secured by the IP Collateral, (2) the lender has exercised its postdefault remedies with respect to the IP Collateral, and (3) by reason of the exercise, a transferee has acquired the rights of the borrower in the collateral, and also set forth (4) the name and mailing address of the secured lender, borrower, and transferee. See Com C §9619(a).

The effect of the statement is not to give the secured lender legal title, but merely to permit the secured lender to pass legal or record title to a transferee at foreclosure. See Com C §9619(b). The transfer effected by a transfer statement is not itself a "disposition of collateral" under UCC Article 9 and does not relieve the secured lender of its UCC Article 9 obligations with respect to the collateral. Com C §9619(c).

Beyond providing for the transfer statement, the security agreement should also include a grant by the borrower of a power of attorney to the lender or the lender's nominee to execute any necessary transfer documents or take other necessary steps to maintain and defend the validity of any registered IP Collateral on the borrower's behalf on an event of default. If the borrower is unable (or unwilling) to effectively maintain or defend the IP Collateral, the power of attorney will enable the lender to take necessary steps to preserve its collateral. A case from the Tenth Circuit suggests that a power of attorney alone might be sufficient to transfer title to patents without need to resort to a transfer statement or take other intermediate steps. See *Electrical Constructors, LLP v Tower Tech, Inc. (In re Tower Tech, Inc.)* (10th Cir 2003) 67 Fed Appx 521, 524 (unpublished opinion).

If the lender's security interest was obtained through a conditional assignment of the IP Collateral from the borrower and the assignment was duly recorded with the appropriate office, the lender will already have record ownership of the IP Collateral. The lender will thus be able to dispose of the IP Collateral by transferring legal title to a third party or else foreclose on the IP Collateral in partial or full satisfaction of the debt. See §9.143. Furthermore, as record owner of the IP Collateral, the secured lender under a conditional assignment will also be able to sue the borrower for infringement, assuming that continued use of the IP Collateral by the borrower after an event of default is disallowed under the terms of the loan agreement.

NOTE: Despite use of a transfer statement, a secured lender may not be able to prevent the borrower from using IP Collateral before foreclosure. UCC Article 9 does not expressly permit the secured lender to stop the borrower from using the IP Collateral following an event of default. It is doubtful that the rights a secured lender acquires under a transfer statement are sufficient to entitle the lender to sue the borrower for infringing or misappropriating IP Collateral that the lender has merely taken control of but has not yet foreclosed on. See *DigiGAN, Inc. v iValidate, Inc.* (SD NY 2004) 71 USPQ2d 1455 (lender permitted to sue borrower for patent infringement after taking collateral in satisfaction of debt); Ward, Intellectual Property §3:34.

If the lender is unable to employ one of the above methods of gaining control, the lender may try to obtain a court order granting the lender power of attorney to execute the necessary transfer documents. Alternatively, the lender could seek the appointment of a court receiver tasked with the responsibility of obtaining control over the IP and disposing of it. This latter approach has the benefit of helping the lender avoid any potential liability over a commercially unreasonable disposition of the IP Collateral. The drawback of either of these approaches, however, is that seeking judicial assistance is time-consuming, and a bad-faith borrower could exploit the delay to dispose of the IP Collateral or

otherwise frustrate the lender's ability to realize on its security interest.

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§9.142 3. Electronic Self-Help

A software company that sells its software on credit and takes back a security interest may have the ability to embed code in the software that the seller can use to disable the program if the buyer-borrower defaults. Such a measure is sometimes called "electronic self-help." Courts have been reluctant to permit secured lenders to use such a device, particularly if it threatens the borrower's ability to continue its business operations. See, *e.g., Clayton X-Ray Co. v Professional Sys. Corp.* (Mo. App 1991) 812 SW2d 565, 567. In the few cases where its use has been permitted, there was a clear agreement entered into beforehand in which the seller-lender fully disclosed the inclusion of such code and its intention to use it if the buyer-borrower defaulted.

NOTE: Any seller-lender who wishes to resort to electronic self-help must be careful not to run afoul of the Computer Fraud and Abuse Act (18 USC §1030). That law prohibits anyone from knowingly causing the transmission of a program intended to deny use of a computer or computer system without authorization of the person or entity that owns or is responsible for the system. See 18 USC §1030(a)(5)(A).

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§9.143 D. Stage 3: Realizing on Value of Collateral

Once the secured lender has obtained the power to transfer the underlying intellectual property rights, the lender has basically two ways of proceeding under UCC Article 9: (a) to dispose of the collateral in a commercially reasonable manner in either a public or private disposition, or (b) if the borrower does not object, to keep the collateral in satisfaction of the borrower's debt.

If the lender proceeds under the first alternative, it can sue the borrower for any deficiency between the proceeds of disposition and the amount owed by the borrower. Although a surplus is usually unlikely, the lender must turn over any surplus first to any junior lien holders, and then to the borrower. See Com C §9615(a). If the lender proceeds under the second alternative, the lender cannot sue for any deficiency unless the borrower consented to the lender's retention of the collateral in partial satisfaction of the secured obligation. In the unlikely event that the fair market value of the collateral exceeds the amount owed, the lender may keep the overage. The second alternative is sometimes called "strict foreclosure." To the extent that the IP Collateral consists of receivables, the secured lender can simply instruct the borrower's account debtor to pay the secured lender directly instead of paying the borrower. Com C §9607.

Each of these procedures must comply strictly with Com C §§9620-9622.

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1. Disposing of Collateral in General

§9.144 a. Public Versus Private Disposition

UCC Article 9 permits the secured lender to dispose of collateral in either a public or a private disposition, but the secured lender disposing of IP Collateral can only be the purchaser if it conducts a public sale. See Com C §9610(c); Official Comment 7 to UCC §9-610. The borrower cannot waive this protection.

UCC Article 9 does not expressly define "public" or "private," but Official Comment 7 to UCC §9-610 describes a "public sale" as one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. "Meaningful opportunity" means that some form of advertisement or public notice must precede the sale and that the public (or the commercially relevant segment of the public) has access to the sale. See Official Comment 7 to UCC §9-610. In either case, the disposition must be done in a "commercially reasonable" manner, as described in §9.145. Com C §9610(b); Official Comment 3 to UCC §9-602. In fact, if it would not be commercially reasonable to conduct a public sale, then the sale must be private, and vice versa. See Ward, Intellectual Property in Commerce §3:57 (West Group 2009).

A purchaser or licensee of IP Collateral almost always wants representations and warranties that the underlying intellectual property is valid and enforceable and does not infringe or misappropriate the rights of any third parties, as well as recourse if the representations and warranties prove to be false. If the seller or licensor is unable to make such representations, a lower purchase price or royalty may result, yet such representations are difficult to give in a public sale setting. Therefore, for IP Collateral, a private sale is most likely to be a more appropriate means of disposition. See Ward, Intellectual Property §3:57. Given the ubiquity of large online auction sites, particularly for the sale of domain names, and the ease with which relevant segments of the public can be reached through e-mail and the Internet, it may be difficult to challenge the commercial reasonableness of an online auction of registered IP Collateral.

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§9.145 b. Commercial Reasonableness Requirement

Commercial reasonableness requires that every aspect of the disposition, including the method, manner, time, place, and other terms, must be commercially reasonable. Com C §9610(b). UCC Article 9 provides that a disposition of collateral is commercially reasonable if it is (a) made in the usual manner in any "recognized market"; (b) made at the price current in any recognized market at the time of the disposition; or (c) made otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition. Com C §9627(b). Similarly, a "collection, enforcement, disposition, or acceptance" is commercially reasonable if it has been approved in or by (1) a judicial proceeding, (2) a bona fide creditors' committee, (3) a representative of creditors, or (4) an assignee for the benefit of creditors. Com C §9627(c). The fact that the disposition failed to net the highest possible price does not, in and of itself, mean that the disposition was not commercially reasonable. See generally Com C §9627(b). Nevertheless, a low price should cause a court to scrutinize carefully all aspects of the disposition. Official Comment 10 to UCC §9-610. The secured party may itself purchase the collateral at either (1) a public disposition or, (2) if the collateral is of a kind that is customarily sold in a recognized market or is the subject of widely distributed standard price quotations, at a private disposition. Com C §9610(c)(1)-(2). Such a purchase of the collateral by the secured party is most likely to occur if a secured party's attempt to strictly foreclose on the IP Collateral fails. See §9.156.

NOTE: A conditional assignment of the IP Collateral as security for the loan does not excuse the secured lender from disposing of the IP Collateral in a commercially reasonable manner. Although the conditional assignment transfers legal title, it is still governed by Com C §9109 and considered a security interest. Consequently, the conditional assignment itself will not satisfy the UCC requirements for a commercially reasonable disposition, and the secured lender will still need to comply with the requirement of a commercially reasonable disposition.

A secured party who fails to conduct a commercially reasonable disposition can be limited in, or entirely barred from, exercising its right to sue for the shortfall if the sale proceeds are less than the debt owed. Moreover, the borrower can sue the secured party for damages. See Com C §9615. Although the borrower cannot waive the requirement that any disposition be commercially reasonable, the parties can apparently agree on what law governs the issue of commercial reasonableness. See *In re Gott* (Bankr ED Cal 1990) 114 BR 708.

The parties can also agree on standards for measuring commercial reasonableness. Courts will defer to the agreed standards as long as they are not "manifestly unreasonable." See Com C §9603(a); *Ford Motor Credit Co. v Solway* (7th Cir 1987) 825 F2d 1213, 1216.

A disposition of collateral, especially IP Collateral, need not take the form of a sale. It can take the form of a license. See Com C §9610(b). In cases where licensing the IP Collateral will, over the long run, generate more revenues than a present outright sale, the commercial reasonableness requirement might compel the lender to seek a license rather than a sale. See, *e.g., Joseph v 1200 Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778, 780.

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§9.146 c. Notification Requirement

A secured lender who intends to dispose of collateral must notify certain parties beforehand (see Com C §9611(b)), unless the collateral "threatens to decline speedily in value." See Com C §9611(d). In particular, the secured lender must give "a reasonable authenticated notification of disposition" to (1) the borrower, (2) any guarantor or secondary obligor, (3) any other person from whom the secured lender received, before the notification date, an authenticated notification of a claim of an interest in the collateral, and (4) any other secured party or lien holder that, 10 days before the notification date, held a security interest in or other lien on the collateral that is perfected. Com C §9611(c). This notification can be waived with respect to the borrower or any secondary obligor by the borrower or such secondary obligor (as the case may be) but only after, not before, default. Com C §9624(a). The required form and contents of this notification are set forth in Com C §9613.

An issue often disputed is what other subordinate secured creditors and lien holders are entitled to notice of disposition under Com C §9611(c)(3)(B) ((4) in the paragraph above). Under §9611(c)(3)(B), the secured lender must give notice to any other secured party or lien holder that has perfected its security interest, regardless of whether the secured lender has actual knowledge of that other party's existence. If the collateral being disposed of consists of registered copyrights, this requirement can be a problem because there is a lag time of several months between the time that security interests are recorded in the Copyright Office and the time that they appear in the Copyright Office database. See Ward, Intellectual Property in Commerce §3:47 (West Group 2009).

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2. Disposing of IP Collateral in Particular

§9.147 a. Patents and Patent Applications

When disposing of patents in a commercially reasonable manner, a secured creditor may utilize the services of entities specializing in the sale and licensing of patents. Further, many large companies subscribe to computer databases that list patents available for licensing and sale. Commentators have suggested that both avenues are commercially reasonable ways of disposing of patents or patent applications. See Ruda, Asset Based Financing: A Transactional Guide §31.03[6] (1985).

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§9.148 b. Inbound Patent Licenses

A secured lender wishing to dispose of a patent license is unlikely to be able to do so without consent of the licensor unless the license expressly permits assignment. This is certainly true if the license is nonexclusive. See *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673. It may also be true if the license is exclusive. See *In re Hernandez* (Bankr D Ariz 2002) 285 BR 435.

Commercial Code §9408(a) and (c) permit a borrower to grant a security interest in an inbound intellectual property license despite any contractual or legal restrictions against doing so. Commercial Code §9408(d), however, protects the licensor or account debtor from any adverse effect of the security interest by preserving the licensor's rights to the extent that a restriction rendered ineffective by §9408(a) or (c) would be effective under law other than UCC Article 9.

Most inbound intellectual property licenses do, in fact, contain prohibitions on assignment that are effective under other law. Although courts differ on whether federal or state law governs the issue of assignability, most cases hold that intellectual property licenses cannot be assigned without the licensor's consent even if the license is silent on the issue. In other words, under "other law," most intellectual property licenses must contain a clause affirmatively permitting assignment by the licensee in order for the license to be assignable by the licensee without the licensor's consent. See, *e.g., Everex Sys., Inc.,* 89 F3d at 679 (patent license is not assignable absent licensor's consent); *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774 (exclusive copyright licenses, not merely nonexclusive copyright licenses, not assignable absent licensor's consent). But see *Farmland Irrig. Co. v Dopplmaier* (1957) 48 C2d 208, 308 P2d 732 (doubting federal common law of presumptive nonassignability of patent licenses); *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404 (finding unpersuasive cases holding that nonexclusive patent licenses are presumptively nonassignable).

If most intellectual property licenses contain "effective" prohibitions on assignment by the licensee, one might ask why the drafters of Com C §9408 would have bothered overriding such an anti-assignment/anti-mortgage clause for the purpose of allowing the borrower-licensee to grant a security interest in the license, but not also override the provision for purposes of allowing a secured lender to exercise its remedies in that security interest. The short answer is that §9408 is simply intended to give the secured lender a place near the front of the line of creditors if the licensee files bankruptcy. See Official Comment 7 to UCC §9-408. A secured lender generally wants the right to foreclose on its collateral or exercise other available remedies in the event of default without waiting for the licensee to file a bankruptcy case. Moreover, because most security agreements prohibit the borrower from granting further security interests in the same collateral, a literal reading of Com C §9408 could render such a prohibition unenforceable. Therefore, despite the benefits of §9408, if one or more intellectual property licenses are material in value or the main source of revenue from which the secured lender expects to be repaid, the lender should require licensor consent both to the grant of the security interest and to the exercise by the secured lender of its rights under its credit documents and UCC Article 9 if the borrower-licensee defaults.

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§9.149 c. Registered and Unregistered Copyrights

As with other forms of IP Collateral, a "commercially reasonable" disposition of a copyright requires that the secured lender make significant attempts to reach the most logical purchasers. A secured lender wishing to dispose of copyrights should employ industry professionals to appraise and market the collateral. For an example of a commercially *un*reasonable sale of rights to a catalog of musical compositions and related royalties, see *In re Four Star Music Co*. (Bankr MD Tenn 1979) 2 BR 454, 29 UCC Rep Serv 343.

Assuming the disposition of a copyright is commercially reasonable, the procedures for transfer of ownership must comply with the Copyright Act. See *Kingsrow Enters., Inc. v Metromedia, Inc.* (SD NY 1978) 203 USPQ 489, 492 (copyright not transferred by mere physical delivery of copyright certificate absent assignment by holder). Section 201(d) of the Copyright Act (17 USC §201(d)) sets forth the requirements for transfer of ownership of a copyright, as follows:

> (1) The ownership of a copyright may be transferred in whole or in part by any means of conveyance or by operation of law, and may be bequeathed by will or pass as personal property by the applicable laws of intestate succession.
>
> (2) Any of the exclusive rights comprised in a copyright… may be transferred… and owned separately. The owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by [the Copyright Act].

NOTE: Section 201(e) of the Copyright Act (17 USC §201(e)) appears to limit a secured lender's right to cause an involuntary transfer of a borrower's copyrights. The language of §201(e) is misleading, however. It was intended only to limit actions initiated by or for governmental bodies. See *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194, 205; Ward, Intellectual Property in Commerce §3:37 (West Group 2009).

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§9.150 d. Inbound Copyright Licenses

When the collateral is an inbound license, the secured lender is unlikely to be able to dispose of the collateral without the licensor's consent unless the license expressly permits assignment. In the Ninth Circuit, this is so, irrespective of whether the copyright license is exclusive or nonexclusive. See *Gardner v Nike*, *Inc.* (9th Cir 2002) 279 F3d 774. Courts in other jurisdictions adhere to the rule that an exclusive copyright licensee acquires a property right and, as such, "may freely transfer his rights." See *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300, 309 (holding that license agreements relating to animated children's characters were nonexclusive and therefore nonassignable under copyright law without consent of licensor).

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§9.151 e. Trademarks

Commentators have suggested that a secured creditor with a well-recognized and valuable trademark should be able to determine the most logical purchasers of such a mark with relative ease. Entities with the qualifications to market a product bearing a valuable mark should be readily ascertainable, because those entities are likely to be current participants in the same market.

After the borrower's default, the "assignment in gross" issue (see §9.32) arises if the secured party seeks to enforce its security interest in the trademark by taking title to it or by arranging for a conveyance of title to a third party. The problem may be resolved if the trademark is convey to a third party that intends to use the mark for the same types of goods or services, or if the lender or a third party also acquires title to sufficient tangible assets in addition to the mark to operate the business under the mark in a manner consistent with the quality level established by the borrower. See Ruda, Asset Based Financing: A Transactional Guide §§31.05[5] n13, 31.05[6] (1985).

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§9.152 f. Trademark Licenses

A secured lender wishing to assume or dispose of collateral that is an inbound trademark license may not do so without consent of the licensor, unless the license expressly permits assignment. In *Miller v Glenn Miller Prods., Inc.* (9th Cir 2006) 454 F3d 975, the Ninth Circuit Court of Appeals held that a trademark licensee may not sublicense its rights without the express consent of the licensor. The trademark license in the case was nonexclusive, but the court did not limit its holding to instances involving nonexclusive trademark licenses. If a licensee cannot grant sublicenses without the licensor's consent, logically the licensee should not be permitted to assign its rights without the licensor's consent either.

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§9.153 g. Trade Secrets

A trade secret may be the subject of a sale or license. Because technical trade secrets are essentially nonpatented inventions, commentators have suggested that secured lenders utilize the same commercial channels when disposing of patents and technical trade secrets. See Ruda, Asset Based Financing: A Transactional Guide §31.04[6] (1985). Nontechnical trade secrets are often sold as part of an ongoing business. Note, however, that to protect the trade secret status of the collateral, the lender must obtain written agreements from prospective purchasers not to use or divulge the trade secret (unless they ultimately purchase or license the collateral in the disposition). Policing such agreements is difficult and often not worth the risk that a trade secret may fall into the wrong hands and thereby lose much or all of its value.

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§9.154 h. Trade Secret Licenses

A trade secret license agreement creates a confidential relationship between the licensor and the licensee under which the licensor reveals the trade secret. The licensor may place restrictions or conditions on the use of a trade secret. Such restrictions would typically limit the secured lender's ability to dispose of its collateral.

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§9.155 3. Distributing Proceeds of Disposition of Collateral

The proceeds from the secured lender's disposition of collateral are required to be distributed in the following order: (1) to the costs of foreclosure, (2) to satisfaction of the debt, (3) to satisfaction of any subordinate security interest or other subordinate lien when the holder provides the lender with an "authenticated demand for proceeds" before distribution is complete, and (4) to the borrower. See Com C §9615(a). If the proceeds fall short of amounts owed to the lender or subordinate secured creditors, the borrower is liable for the deficiency. See Com C §9615(d).

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§9.156 4. Keeping Collateral in Satisfaction of Debt ("Strict Foreclosure")

A secured party may propose to retain collateral in partial or full satisfaction of the debt even if the secured party was not in possession of the collateral, and even if the collateral is intangible. See Official Comment 7 to UCC §9-620. If the secured lender proposes strict foreclosure in full satisfaction of the debt, the secured lender will waive its right to collect any deficiency from the borrower, and the borrower will give up its right to any surplus. If the strict foreclosure is only in partial satisfaction of the debt, the secured lender will be able to seek recovery of the outstanding balance of the debt as an unsecured creditor. Accordingly, while the borrower has a right to object to either form of strict foreclosure, the borrower's failure to object will only be considered consent in the case of strict foreclosure as full satisfaction of the debt, and will remain subject to certain conditions. See Com C §9620(c)(2); Official Comment 3 to UCC §9-620. Few borrowers object, however, because their collateral is more often worth less, not more, than the debt they owe.

A secured party who proposes to retain collateral in satisfaction of the debt must notify other parties who claim an interest in the collateral, whether secured or unsecured. See Com C §9621.

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§9.157 VIII. CONCLUSION

The challenges of secured lending transactions involving intellectual property are many. They include determining what kind of intellectual property is included in the collateral and, when the forms of intellectual property overlap each other, how to reconcile differences among the rules that apply to each different form. The challenges also include determining which UCC Article 9 category of property the particular form of intellectual property falls under and how the method of perfecting security interests in that category applies to the intellectual property collateral. They include determining how the UCC Article 9 priority rules are affected by federal laws that govern the transfer of intellectual property rights. And overarching all of these challenges is the uncertainty concerning what law governs each issue—federal or state and, if state, which states' laws apply—and what choice-of-law rules should be applied.

Notwithstanding these challenges, the need to be able to extend credit and secure repayment obligations with a borrower's intellectual property assets is greater than ever. The U.S. economy in general and California's economy in particular is increasingly reliant on intellectual property, and the value of those assets continues to grow, making them ever more attractive as collateral. In periods of economic decline or hardship, commercial lenders and borrowers alike become increasingly concerned about their rights to such collateral. Knowing how to lend and borrow against intellectual property is critical for attorneys representing commercial lenders or borrowers in this information age.

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10

Federal Income Tax Issues

Timothy J. Fitzgibbon
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§10.1 I. INTRODUCTION

Many U.S. federal income tax issues can arise with respect to intellectual property. This chapter provides an overview of some of the more typical tax issues associated with the development, ownership, and acquisition or disposition of intellectual property. It also discusses various tax structuring considerations involving intellectual property. Except for a brief discussion of certain topics in §§10.21 and 10.28, this chapter does not address California tax issues or any type of tax other than income tax.

The transfer or disposition of intellectual property can raise numerous tax considerations. One of the more important initial concerns is whether the transaction will be characterized as either a sale or a license for tax purposes. As explained in §§10.3-10.11, a transfer is generally characterized as a sale only if all substantial rights to the intellectual property have been transferred from the buyer to the purchaser.

Developing intellectual property also raises a number of unique tax considerations. Sections 10.12-10.14 discuss the application of IRC §174, which provides taxpayers with an election to either deduct certain qualified research and development expenditures paid and incurred in connection with a present trade or business or to amortize such expenses over a period of not less than 5 years. Section 10.15 discusses the IRC §41 research credit, which gives taxpayers an important incentive to conduct research and development activities in the United States.

Sections 10.16-10.38 examine various tax considerations that may be involved in acquisitions and dispositions involving intellectual property, *e.g.,* whether the transaction should be structured as an asset or stock transfer and whether it will be taxable or nontaxable. Sections 10.39-10.46 highlight important international tax issues that can arise in cross-border transactions involving intellectual property.

Sections 10.47-10.54 discuss various tax considerations relating to intellectual property owned by an offshore taxpayer. For example, royalty payments made by a U.S. person to a foreign person are potentially subject to U.S. withholding tax under IRC §871(a) or §881. Failure to withhold when required to do so under IRC §§1441-1442 can be a costly mistake, because the ultimate liability for the withholding tax rests with the withholding agent. Finally, §§10.55-10.74 discuss a number of issues that commonly arise with respect to the application of the antideferral rules in Subpart F of the Internal Revenue Code (IRC §§951-965), as well as the application of IRC §482.

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II. CHARACTERIZATION ISSUES

§10.2 A. Overview

The tax characterization of transactions involving intellectual property is a key threshold issue, *i.e.,* whether a transaction resulting in the transfer of intellectual property from one taxpayer to another should be characterized as a sale or exchange of that property, or alternatively as a license for the use of the property (or provision of services). The answer to this characterization issue can give rise to materially different results, and the labels used in transactional documents are not controlling. Rather, the underlying substance of the transaction will control. See *Boulez v Comm'r* (1984) 83 TC 584.

If there has been a transfer of all substantial rights in a taxable transaction, the transfer is generally treated as a sale or exchange. See §10.3. Capital gain treatment generally results in an income inclusion equal to the difference between the amount realized and the taxpayer's adjusted basis in the property, and the buyer takes a cost basis in the property, which can usually be amortized over a 15-year period.

NOTE: The "all substantial rights" test does not generally apply to transfers of intellectual property rights under IRC §351 (transfer to controlled corporation in exchange for stock) or §721 (transfer to partnership in exchange for partnership interest). See §§10.37-10.38.

If there has not been a transfer of all substantial rights, the transaction is generally treated as a license, which gives rise to royalty income. Royalty income is ordinary income, and no recovery of basis is permitted. As discussed in §10.49, the withholding tax liability must be considered when a U.S.-source royalty is paid to a foreign person (a withholding issue can also arise on the sale of certain intellectual property if the payments are contingent on the productivity, use, or disposition of the property). For amortizable assets, the licensor can continue to amortize the asset.

Taxpayers should compare carefully the rights transferred with the rights retained to determine whether a transfer of intellectual property will be treated as a sale generating capital gain or as a license generating royalty income.

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§10.3 B. "All Substantial Rights" Test

To determine whether a transfer of intellectual property should be characterized for tax purposes as a sale or a license, courts and the Internal Revenue Service examine whether "all substantial rights" in the property have been transferred. Whether all substantial rights have been transferred is generally determined by what has been *retained* by the transferor, not by what has been given up. Each retained right must be examined both separately and collectively with other retained rights. *C.A. Norgren Co. v U.S.* (D Colo 1967) 268 F Supp 816, 819.

EXAMPLE: In C.A. Norgren Co., the taxpayer assigned patent rights to two companies. The court stated that the question is not what rights the transferee received, but what rights were relinquished by the transferor. Thus, the fact that the transferor contemporaneously assigned patent rights to two companies, one receiving the right to sell and the other the right to manufacture and use, would make no difference because the taxpayer still parted with all substantial rights.

The IRS will normally look at the substance of the transaction rather than its form. See *Boulez v Comm'r* (1984) 83 TC 584. In *C.A. Norgren Co., v U.S., supra,* the court explained that the nomenclature used by the parties to a patent agreement is not determinative of the legal characterization to be placed on the transaction. The fact that the agreement at issue was labeled a "license" and the payments incident to it were referred to as "royalties" did not preclude a finding that an effective assignment took place for tax purposes.

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§10.4 1. Cases Involving Transfers of All Substantial Rights

The courts and the IRS have identified a number of situations that result in a transfer of all substantial rights, including:

- A transfer of an exclusive right. Rev Rul 64-56, 1964-1 Cum Bull 133 (the IRS stated that the all substantial rights test is met if exclusive and perpetual right to use know-how and to make, use, and sell the product in a particular country is transferred).

- A transfer of an exclusive right to use a trade secret until it becomes public knowledge and no longer protectible under the laws of a foreign country. Rev Rul 71-564, 1971-2 Cum Bull 179 (unqualified transfer of exclusive right to use trade secret until it becomes public knowledge and no longer protectible under laws of the country where transferee operates is transfer of property under IRC §351).

- A transfer of all the remaining rights in a patent held by the transferor, even though other rights are outstanding. *MacDonald v Comm'r* (1971) 55 TC 840 (taxpayers transferred all substantial rights in patents when taxpayers transferred all rights that they held, even though nonexclusive rights were held by others).

- A transfer of geographically segregated rights. See *Watson v U.S.* (10th Cir 1955) 222 F2d 689 (transfer of all or an undivided share of an exclusive right to make, use, and sell invention throughout the United States or exclusive right within a specified area of the United States constitutes assignment of patent; transfer of lesser right is not an assignment but a license).

- The rights transferred can be restricted to a particular industry (fields of use). *U.S. v Carruthers* (9th Cir 1955) 219 F2d 21, 24 (transfer of exclusive license to patent that was limited to "tuna canning industry" constituted a sale).

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§10.5 2. Cases Not Involving Transfer of All Substantial Rights

The following types of transfers will generally not result in a transfer of all substantial rights:

- A transfer of a nonexclusive right generally results in a license. See *Commercial Solvents Corp. v Comm'r* (1964) 42 TC 455, 468 (taxpayer retained valuable rights in trade secrets and did not transfer all substantial rights in its secret processes).

- A transfer of a right for less than the useful life of an asset results in a license. See *Pickren v U.S.* (5th Cir 1967) 378 F2d 595 (transfer of secret formulas and trade names resulted in ordinary income because rights were transferred for less than their useful life).

- A right to terminate the transfer agreement at will constitutes the retention of a substantial right. See *Taylor-Winfield Corp. v Comm'r* (1971) 57 TC 205, aff'd (6th Cir 1972) 467 F2d 483 (transfers did not convey all substantial rights in subject matter covered by agreement because transferor retained right to terminate agreement). If, however, the right to terminate is beyond the control of the transferor, the agreement would constitute the transfer of all substantial rights. *Bell Int'l Corp. v U.S.* (Ct Cl 1967) 381 F2d 1004 ("a transfer… terminable by the grantor not on the happening of a future event beyond his control but at his own discretion prior to the patent's expiration date will ordinarily constitute a licensing arrangement rather than a sale").

- A transfer of an undivided interest generally results in a license if the co-owners do not share equally in the rights to the patent. See *Eickmeyer v U.S.* (Cl Ct 1986) 10 Cl Ct 598, 600 (transfer agreements were licenses, because they allowed taxpayer to retain right to collect for all uses of patent, making subsequent third party purchaser accountable to taxpayer).

- A requirement in the transfer agreement that a subsequent assignee account to the original transferor could result in a license. 10 Cl Ct at 600.

- Failure to grant the right to sue for infringement in the transferee's own name could result in a license characterization. 10 Cl Ct at 600.

- Retaining rights to future development could constitute the retention of a substantial right and, as such, constitute a license. See *McDermott v Comm'r* (1963) 41 TC 50, 58 (withholding rights in future design or invention negated existence of a sale); Field Service Advice 200006024 (Nov. 5, 1999) (IRS stated in footnote that retained right to future development is a substantial right not transferred).

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§10.6 C. IRC §1235's Limited "All Substantial Rights" Test

When an individual transfers a patent, taxpayers must be aware of the more stringent "all substantial rights" test in IRC §1235 for purposes of determining whether the transaction should be characterized as a sale or license.

Section 1235 provides a deemed capital gain treatment for transfers of patent rights by individual taxpayers. It applies to certain transfers of patent rights by a "holder" of those rights. A "holder" is defined as (1) any individual whose efforts created the property, or (2) any other individual who acquired his or her interest in the property in exchange for consideration in money or money's worth paid to the creator before actual reduction to practice of the invention covered by the patent, if such individual is neither (a) the employer of that creator, nor (b) related to that creator. IRC §1235(b).

NOTE: Section 1235 is very limited in its application. If a transfer is not one described in IRC §1235(a), §1235 is disregarded in determining whether or not the transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a "holder," or a transfer by a holder to a related person, is not governed by §1235. Treas Reg §1.1235-1(b).

For determining whether capital gain treatment applies to the proceeds from the transfer of a patent, IRC §1235 sets forth an "all substantial rights" test that is more stringent than the "all substantial rights" test discussed in §§10.3-10.5. The more stringent test is applicable only in the case of a transfer of a patent by an individual. In other situations, the test discussed in §§10.3-10.5 applies.

Under Treas Reg §1.1235-2(b)(1), the term "all substantial rights to a patent" is defined more narrowly than in the case law described in §§10.3-10.5. Under the regulations, "all substantial rights" is defined to mean all rights (whether or not then held by the grantor) that are of value at the time the rights to the patent (or an undivided interest in the patent) are transferred. The regulations provide that the term "all substantial rights to a patent" does not include a grant of rights to a patent that (Treas Reg §1.1235-2(b)(1)(i)-(iv), (4)):

- Is limited geographically within the country of issuance. See *Marco v Comm'r* (1955) 25 TC 544 (transfer of exclusive rights to make, use, and sell invention to area west of Mississippi River is entitled to capital gains treatment). This requirement is not consistent with case law outside of §1235.
- Is limited in duration by the terms of the agreement to a period less than the remaining life of the patent.
- Grants rights to the grantee, in fields of use within trades or industries, that are less than all the rights covered by the patent and that exist and have value at the time of the grant. See *Rouverol v Comm'r* (1964) 42 TC 186, nonacq 1965-2 Cum Bull 7 (limitation of transferee's exclusive rights to particular field of use resulted in transfer of "all substantial rights"). This requirement is not consistent with case law outside of §1235.
- Grants to the grantee less than all the claims or inventions covered by the patent that exist and have value at the time of the grant.
- Results in the retention of a right to terminate the transfer at will.

The regulations provide examples of rights that the holder can retain and still be treated as transferring all substantial rights to a patent. Examples include: (1) retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent; (2) retention by the transferor of rights in the property that are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien); and (3) a reservation in the nature of a condition subsequent, such as a provision for forfeiture on account of nonperformance. Treas Reg §1.1235-2(b)(2).

Examples of rights that may or may not be substantial, depending on the circumstances of the overall transaction, include: (1) the retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee; and (2) the failure to convey to the transferee the right to use or to sell the patent property. Treas Reg §1.1235-2(b)(3).

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D. Computer Program Transactions (Treas Reg §1.861-18)

§10.7 1. In General

Transactions involving computer programs are subject to a special set of characterization rules set forth in the regulations under IRC §861. For purposes of the regulations, a "computer program" is defined as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. A computer program includes any media, user manuals, documentation, database, or similar item of media, as well as any similar item incidental to the operation of the computer program. Treas Reg §1.861-18(a)(3). The regulations generally require that software transactions be characterized in one of the following four ways: (1) as a transfer of a copyright right in the computer program; (2) as a transfer of a copy of the computer program (a copyrighted article); (3) as the provision of services for the development or modification of the computer program; or (4) as the provision of know-how relating to computer programming techniques. Treas Reg §1.861-18(a)(2), (b)(1). Any transaction involving computer programs that consists of more than one of the transactions described above is bifurcated and tested as two or more separate transactions. However, a transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, is not to be treated as a separate transaction. Treas Reg §1.861-18(b)(2).

In the case of a transfer of software that constitutes a transfer of a "copyright right," the regulations provide rules for determining whether the transaction should be classified as a sale or exchange or as a license generating royalty income. In the case of a transfer of software that constitutes a transfer of a "copyrighted article," the regulations provide rules for determining whether the transaction should be classified as a sale or exchange or as a lease generating rental income. Treas Reg §1.861-18(a)(2).

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§10.8 2. Copyright Rights

A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the following rights (Treas Reg §1.861-18(c)(1)(i), (2)(i)-(iv)):

- The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending;
- The right to prepare derivative computer programs based on the copyrighted computer program;
- The right to make a public performance of the computer program; or
- The right to publicly display the computer program.

Whether the transaction is treated as solely constituting a transfer of a copyright right or is bifurcated into separate transactions is determined under Treas Reg §1.861-18(b)(1)-(2). Treas Reg §1.861-18(c)(1)(i). For example, if a person receives a disk containing a copy of a computer program that enables him or her to exercise, in relation to that program, a non-de-minimis right (and the transaction does not involve, or involves only a de minimis provision of, services (see Treas Reg §1.861-18(d) and §10.10) or know-how (see Treas Reg §1.861-18(e) and §10.11)), then the transfer is classified solely as a transfer of a copyright right. Treas Reg §1.861-18(c)(1)(i). Similarly, a determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. Income derived from the sale or exchange of a copyright right will be sourced under IRC §865(a), (c), (d), (e), or (h), as appropriate. Treas Reg §1.861-18(f)(1).

A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. Treas Reg §1.861-18(f)(1). See IRC §§1222, 1235. Income derived from the licensing of a copyright right will be sourced under IRC §861(a)(4) or §862(a)(4), as appropriate. Treas Reg §1.861-18(f)(1). See §10.9.

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§10.9 3. Copyrighted Articles

If a person acquires a copy of a computer program, but does not acquire any of the copyright rights described in §10.8 (or only acquires a de minimis grant of those rights) and the transaction does not involve the provision of services or know-how (or only a de minimis amount), the transfer is classified solely as a sale of a copyrighted article. Treas Reg §1.861-18(c)(1)(ii). A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, in the main memory or hard drive of a computer, or in any other medium. Treas Reg §1.861-18(c)(3). A determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership associated with that copyrighted article have been transferred. Treas Reg §1.861-18(f)(2). Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under IRC §861(a)(6), §862(a)(6), §863, or §865(a), (b), (c), or (e), as appropriate. Treas Reg §1.861-18(f)(2).

A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Treas Reg §1.861-18(f)(2). Income derived from the leasing of a copyrighted article will be sourced under IRC §861(a)(4) or §862(a)(4), as appropriate. Treas Reg §1.861-18(f)(2).

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§10.10 4. Provision of Services

The determination of whether a transaction involving a newly developed or modified computer program is characterized as a provision of services or as another transaction (*i.e.,* a sale or license of intellectual property rights) is based on all the facts and circumstances of the transaction. Treas Reg §1.861-18(d). Appropriate facts, such as the intent of the parties (as evidenced by their agreement and conduct) regarding which party is to own the copyright rights in the computer program and how the risks of loss are to be allocated between the parties, are relevant to this analysis. Treas Reg §1.861-18(d).

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§10.11 5. Provision of Know-How

The provision of information with respect to a computer program will be treated as the provision of know-how only if the information (1) relates to computer programming techniques, (2) is furnished under conditions preventing unauthorized disclosure under the terms of the contract, and (3) is considered property subject to trade secret protection. Treas Reg §1.861-18(e).

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III. RESEARCH AND DEVELOPMENT EXPENSES

§10.12 A. Overview of Statutory Framework

Internal Revenue Code §41 provides taxpayers a research credit of 20 percent for certain qualified research or experimental expenses to the extent that current year research expenditures exceed a base amount. IRC §41. See §10.15. Internal Revenue Code §38 gives taxpayers a "current year business credit," which is defined to include the research credit. IRC §38(b)(4).

Internal Revenue Code §174 provides taxpayers with an election either to deduct research and experimental expenditures paid or incurred in connection with a present trade or business or to amortize those expenses over a period of not less than 5 years. IRC §174(a), (b). Section 174 was designed to reverse statutorily the IRS's historical position that research expenditures were capital in nature and to clarify that these expenditures are deductible if the taxpayer elects. See §10.13.

Internal Revenue Code §280C(c) reduces the §174 deduction or amortization to the extent of the credit claimed under §41. Taxpayers, however, may elect to reduce the amount of the research credit instead. If this election is made, no reduction of the §174 amount is made. Instead, the amount of the credit will equal the excess of the amount of credit determined under §41(a), over the product of (1) the amount of credit determined under §41(a), and (2) the maximum rate of corporate tax. IRC §280C(c)(1)-(3). See IRC §11(b)(1). For example, if the §41 credit equals $100,000, then the reduced credit would be $65,000 ($100,000 minus $35,000 ($100,000 × 35%)). An election for any taxable year must be made no later than the time for filing the tax return for that year (including extensions), must be made on the return, and must be made in the manner prescribed by the IRS. Once made, the election is irrevocable for that tax year. IRC §280C(c)(3)(C).

Many considerations may be relevant in determining whether to make an election to reduce the amount of the research credit. For instance, a taxpayer may benefit from the election under state law. Many states use federal taxable income as a starting point for determining income subject to state taxation. Some states might not allow downward adjustments to federal taxable income to offset the §280C increase. In those states, the taxpayer may have high taxable income for state tax purposes. An election to reduce the research credit would help alleviate this problem. A taxpayer also might want to make the election in order to increase its net operating losses. For instance, if the taxpayer paid taxes in the prior 2 years, the taxpayer may wish to make the election so that its current year operating loss could be increased and then carried back. Finally, the election affects the foreign tax credit limitation. If the taxpayer does not make the election, then the §174 deduction can be reduced. (The deduction might be apportionable to foreign source income.) Without the §174 deduction, foreign source income might remain at a higher level. As a result, a taxpayer might be able to claim a greater foreign tax credit.

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§10.13 B. IRC §174 Deduction for Research Expenses

Under IRC §174, a taxpayer may currently deduct research or experimental expenditures paid or incurred during the taxable year in connection with the taxpayer's trade or business. IRC §174(a). Alternatively, the taxpayer may elect to amortize these expenses ratably over a period of not less than 5 years. IRC §174(b). Research or experimental expenditures that are neither treated as expenses nor amortized under §174 may instead be amortized over 10 years under IRC §59(e). If the taxpayer does not employ any of these three methods, then the expenditures must be capitalized. Treas Reg §1.174-1.

The term "research or experimental expenditures," as used in §174, means reasonable expenditures incurred in connection with the taxpayer's trade or business that represent research and development (R&D) costs incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Treas Reg §1.174-2(a)(1), (6). See also Treas Reg §1.174-2(a)(2) (defining product). The term generally includes all such costs incident to the development or improvement of a product, whether incurred by the taxpayer or on its behalf. Treas Reg §1.174-2(a)(1), (8). The term includes the costs of obtaining a patent, such as attorney fees expended in making and perfecting a patent application. Treas Reg §1.174-2(a)(1).

Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement that the product or improvement represents. Treas Reg §1.174-2(a)(1). The regulations specify that the term "research and experimental expenditures" does not include expenditures for (1) ordinary testing or inspection for quality control (see Treas Reg §1.174-2(a)(4)), (2) efficiency surveys, (3) management studies, (4) consumer surveys, (5) the acquisition of another's patent, model, production, or process, or (6) research in connection with literary, historical, or similar projects. Treas Reg §1.174-2(a)(3).

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§10.14 C. Expensing R&D Expenditures

Under IRC §174(a), if the taxpayer chooses to expense research and experimental expenditures currently, the taxpayer may adopt the expensing method in the first year for which the taxpayer incurs those expenditures. See IRC §174(a)(2). A taxpayer can effectively elect the current expense method merely by claiming the deduction of research and experimental expenditures in its income tax return, even if the taxpayer provides no special designation or identification. IRC §174(a)(2)(A); Treas Reg §1.174-3(b)(1); Rev Rul 58-356, 1958-2 Cum Bull 104. To adopt the method in subsequent years, the taxpayer must obtain the IRS's permission to do so. IRC §174(a)(2)(B); Treas Reg §1.174-3(b)(2).

Once adopted, the method applies to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent years unless the IRS authorizes a different method. IRC §174(a)(3); Treas Reg §1.174-3(a). The regulations provide rules for requesting a change of method from the IRS, including rules for adopting a different method solely for a particular project or projects. See Treas Reg §1.174-3(b)(3).

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§10.15 D. IRC §41 Research Credit

Under IRC §41(a), for purposes of IRC §38, the research credit for the taxable year equals the sum of 20 percent of any excess of (1) the qualified research expenses for the taxable year, over (2) the base amount. The §41 research credit also equals 20 percent of certain basic research payments (see IRC §41(a)(2)) and certain amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including contributions to an energy research consortium). See IRC §41(a)(3).

Qualified research expenses. The term "qualified research expenses" means the sum of the following amounts paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (1) in-house research expenses, and (2) contract research expenses. IRC §41(b)(1).

In-house research expenses. "In-house research expenses" are defined to include the following:

- Wages paid or incurred to an employee for qualified services. See IRC §41(b)(2)(B), (D). "Wages" means all remuneration for services performed by an employee for his or her employer. The compensation must be subject to wage withholding. IRC §41(b)(2)(D). The term "qualified services" means services consisting of (1) engaging in qualified research (see Treas Reg §1.41-2(c)(1)), or (2) engaging in the direct supervision or direct support of research activities that constitute qualified research. IRC §41(b)(2)(B). "Direct supervision" means the immediate supervision (first-line management) of qualified research (*e.g.*, a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). The term does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist. Treas Reg §1.41-2(c)(2). "Direct support" means services in the direct support of either (1) persons engaging in actual conduct of qualified research, or (2) persons who are directly supervising persons engaging in the actual conduct of qualified research. Treas Reg §1.41-2(c)(3).

NOTE: If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. All of the services will be deemed qualified services, however, if at least 80 percent of the wages paid to the employee were for qualified services. IRC §41(b)(2)(B); Treas Reg §1.41-2(d)(2).

- Any amount paid or incurred for supplies used in the conduct of qualified research. See IRC §41(b)(2)(C). The term "supplies" means any tangible property, other than land or improvements to land and property of a character subject to the allowance for depreciation. IRC §41(b)(2)(C). Supplies and personal property are used "in the conduct of qualified research" if they are used in the performance of qualified services by an employee of the taxpayer. Expenditures for supplies, or for the use of personal property, that are indirect research expenditures or general or administrative expenses do not qualify as in-house research expenses. Treas Reg §1.41-2(b)(1).

- Any amount paid or incurred to another for the right to use computers in the conduct of qualified research. IRC §41(b)(2)(A). The term "qualified research" means research activities that satisfy each of the following three requirements (Treas Reg §1.41-4(a)(2)):

- The expenditures qualify as deductible research and development (R&D) expenses under IRC §174. R&D expenditures are defined to include those expenditures incurred in connection with the taxpayer's trade or business that represent R&D costs in the experimental or laboratory sense. "Experimental or laboratory sense" refers to expenditures for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Treas Reg §1.174-2(a)(1).

- The research is undertaken to discover technical information, and its application is intended to be useful in the development of a new or improved business component. This requirement is satisfied only if the research is undertaken for the purposes of discovering information that is "technological in nature," and the application of that information is intended to be useful in the development of a new or improved business component of the taxpayer. Treas Reg §1.41-4(a)(2)(ii).

- Substantially all the activities constitute elements of a process of experimentation that relates to a qualified purpose. The phrase "substantially all the activities" is defined to require that 80 percent or more of the taxpayer's research activities constitute elements of a process of experimentation that relates to a qualified purpose. Treas Reg §1.41-4(a)(2)(iii), (6). A process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance,

reliability, or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors. Treas Reg §1.41-4(a)(5)(ii).

Contract research expenses. The phrase "contract research expenses" means 65 percent of any expense paid or incurred by the taxpayer to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of either (1) qualified research (see IRC §41(b)(2)(B)), or (2) services that would be qualified services if performed by employees of the taxpayer. Treas Reg §1.41-2(e). See Treas Reg §§1.41-4, 1.41-4A.

NOTE: Historically, the research credit has been subject to periodic extensions rather than being made permanent. The research credit has been extended to apply to amounts paid or incurred on or before December 31, 2009. IRC §41(h)(1)(B). See the Emergency Economic Stabilization Act of 2008 (Pub L 110-343, §301, 122 Stat 3765). Bills have been introduced in the House of Representatives and the Senate to extend the research credit to apply to amounts paid or incurred on or before December 31, 2020. See HR 422, 111th Cong, 1st Sess (2009) and Growth Research Opportunities with Taxcredits' Help Act, S 1203, 111th Cong (2009). The Obama administration's fiscal 2010 budget proposal (JCS-3-09) proposes to make the research credit permanent.

Alternative Simplified Credit. In June, 2008, the IRS published final and temporary regulations on the election and calculation of the alternative simplified credit under IRC §41(c)(5) for purposes of claiming the research credit. Internal Revenue Code §41(c)(5)(A) provides that at the election of the taxpayer, the research credit will equal 14 percent (12 percent for tax years ending before January 1, 2009) of as much of the taxpayer's qualified research expenses for the taxable year as exceeds 50 percent of the taxpayer's average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined. Internal Revenue Code §41(c)(5)(B) provides that the credit will equal 6 percent of the taxpayer's qualified research expenses for the taxable year if the taxpayer did not have qualified research expenses in each of the 3 taxable years preceding the year for which credit is being determined.

NOTE: Under IRC §41(c)(4), a taxpayer may also compute the research credit by electing the alternative incremental credit, under which the research credit is determined with reference to the gross receipts of the taxpayer for the 4 prior taxable years.

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IV. ACQUISITIONS AND DISPOSITIONS OF INTELLECTUAL PROPERTY

§10.16 A. Overview

If a buyer acquires intangible property from a seller, the tax consequences of the acquisition depend on whether it is structured as a taxable or nontaxable acquisition. Moreover, with an IRC §338 election, an acquisition of intangible property could take the form of an acquisition of stock instead of a direct purchase of the intangible property. Sections 10.17-10.21 discuss various tax considerations in structuring the transaction as taxable or nontaxable or as a stock or asset acquisition. As discussed in §10.18, one important consideration is whether the buyer receives a step-up in basis in the acquired intangible property. A step-up in basis of the intangible property will generally occur in a taxable asset sale, but will generally not occur in a taxable stock sale unless a §338 election is made. Finally, both the buyer and seller must take into account international issues if one or both are foreign persons.

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B. Taxable Asset Sales

§10.17 1. Seller's Considerations

In a taxable asset sale, the seller generally recognizes gain or loss equal to the difference between the amount received for the intangible property and the seller's adjusted basis in the intangible property. IRC §§1001, 1011-1012.

In general, capital gain or loss is recognized if the intangible property is a capital asset within the meaning of IRC §1221. Intangible property, however, may not qualify as a capital asset in certain limited situations. For example, property used by the taxpayer in a trade or business that is subject to depreciation under IRC §167 is excluded from the definition of a capital asset. IRC §1221(a)(2). All IRC §197 intangible assets (*i.e.,* amortizable assets; see §10.20) are treated as property subject to the depreciation allowance under §167. Nevertheless, capital gain or loss treatment may be available under IRC §1231, which applies to depreciable assets used in a trade or business that have been held for more than 1 year. Internal Revenue Code §1221(a)(3), however, excludes from the definition of "capital asset" a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by (1) a taxpayer whose personal efforts created that property, (2) in the case of a letter, memorandum, or similar property, a taxpayer for whom that property was prepared or produced, or (3) a taxpayer in whose hands the basis of that property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of that property in the hands of a taxpayer described in (1) or (2). Computer software might fall under the §1221(a)(3) exclusion if it is copyrightable.

Although the matter is not free from doubt, the §1221(a)(3) exclusion might not apply to corporations that create copyrights because the corporation will not be considered to have made personal efforts that created the copyright material. For example, in *Desilu Prods., Inc. v Comm'r* (1965) TC Memo 1965-307, where the corporate taxpayer produced television films and sold some of the films, the government argued that §1221(a)(3) applied and the court did not discuss the application of §1221(a)(3). See also Rev Rul 55-706, 1955-2 Cum Bull 300 (providing that property created by the corporate taxpayer was "not considered created by the personal efforts of [the corporate taxpayer] where all of the costs and expenses are paid for by the corporation at the current going rate for the services rendered"). Revenue Ruling 55-706 may not be reliable because it was superseded by Rev Rul 62-141, 1962-2 Cum Bull 182. Revenue Ruling 62-141, however, did not discuss the application of §1221(a)(3)).

Another open issue is whether the §1221(a)(3) exclusion applies to property that is both patentable and copyrightable. Treasury Regulation §1.1221-1(c)(1) provides that "for purposes of this subparagraph, the phrase similar property… does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law." This provision suggests that property eligible only for patent protection escapes the scope of §1221(a)(3).

Under recharacterization rules, capital gain on the sale of an intangible asset could be recharacterized as ordinary income. One important recharacterization rule is IRC §1245, which requires gain to be recharacterized as ordinary income to the extent of previous depreciation or amortization attributable to the transferred property. Another recharacterization provision is IRC §1239, which applies to a sale or exchange of property (either direct or indirect) between related persons (applying a more-than-50-percent-ownership test). If applicable, any gain recognized by the seller is treated as ordinary income if the property in the hands of the transferee is of a character that is subject to the §167 allowance for depreciation. In addition, as discussed in §§10.3-10.11, if all substantial rights to the intangible have not been transferred, the seller will be treated as receiving royalties that generate ordinary income.

Another important rule is IRC §267, which disallows a loss on the sale of property between related parties. IRC §267(a)(1), (b). Under §267(f), however, if the sale or exchange of property is between members of a controlled group of corporations, the loss is deferred until the property is transferred outside the controlled group. The purpose of §267(f) is to prevent members of a controlled group from taking a loss or deduction solely as the result of a transfer of property between members of the group. The selling member's loss or deduction from an intercompany sale is taken into account under the timing principles of Treas Reg §1.1502-13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. The matching and acceleration rules generally affect only the timing of a loss or deduction, and not its attributes (*e.g.,* its source and character) or the holding period of property.

A corporate seller's tax attributes are generally available to offset gain on the asset sale, subject to applicable limitations. See, *e.g.,* IRC §382.

If the seller is a corporation, it might liquidate following an asset sale. The liquidation of the selling corporation is tax free if IRC §332 applies. IRC §332(a). Generally, for §332(a) to apply, the controlling shareholder must own at least 80 percent of the voting

power and value of the liquidating subsidiary. See IRC §1504(a). In addition, the liquidating subsidiary's property must be transferred within the taxable year or the liquidating distribution must be one of a series of distributions completed within 3 years from the close of the taxable year during which the first of the series of distributions under the liquidation plan is made. IRC §332(b). If §332 does not apply, then the liquidation will be taxable. Under IRC §331(a), the shareholder of the liquidating corporation recognizes gain or loss equal to the difference between the amount received (cash plus the fair market value of any other property received) in the liquidating distribution and the shareholder's adjusted basis in its stock. Treas Reg §1.331-1(b).

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2. Purchaser's Considerations

§10.18 a. Generally

The main benefit for the purchaser in a taxable asset sale is a step-up in basis in the acquired assets. The basis in the acquired assets will generally equal their cost. IRC §1012. In the acquisition of a single asset, the basis of the acquired asset will generally be the purchase price of the asset as agreed by the purchaser and seller. In an acquisition of multiple assets, the purchaser and seller are usually required to allocate the purchase price among the assets acquired. See §10.19.

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§10.19 b. Allocation of Purchase Price

If applicable, IRC §1060 provides rules for the allocation of the purchase price in an asset acquisition. Section 1060 applies only if there is an applicable asset acquisition, *i.e.*, a transfer (whether direct or indirect) of assets that constitute a trade or business and with respect to which the transferee's basis in the assets is determined wholly by reference to the consideration paid for those assets. IRC §1060(c). A group of assets constitutes a trade or business (Treas Reg §1.1060-1(b)(2)(i)) if either:

- The use of such assets would constitute an active trade or business under IRC §355; or

NOTE: Under Treas Reg §1.355-3(b)(2)(ii), a corporation is treated as engaged in a trade or business "if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit." The group of activities ordinarily must include the collection of income and the payment of expenses. Under Treas Reg §1.355-3(b)(2)(iii), the determination of whether a trade or business is actively conducted is made from all of the facts and circumstances. Generally, the corporation itself is required to perform active and substantial management and operational functions, and activities performed by persons outside the corporation, such as independent contractors, are not included.

- The group of assets is of such a character that goodwill or going concern value could attach to it under any circumstances.

NOTE: Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage, which may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value attributable to the immediate use or availability of an acquired trade or business, such as the use of revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational. Treas Reg §1.1060-1(b)(2)(ii).

When IRC §1060 is applicable, the following tax consequences occur:

- The consideration paid by the acquirer is allocated among the assets purchased in accordance with IRC §338(b)(5). IRC §1060(a). Section 338(b)(5) sets forth rules governing the basis of assets acquired in a qualified stock purchase that the buyer elects to treat as an asset purchase (see IRC §338(g)); the regulations under §338(b)(5) employ the residual method of valuing goodwill and going concern value as part of amortizable IRC §197 intangibles.

- IRS Form 8594 (Asset Acquisition Statement) must be filed with both the seller and acquirer's tax returns for the period that includes the date on which the applicable asset acquisition occurs (Treas Reg §1.1060-1(e)); and

- If the seller and acquirer agreed to a purchase price allocation or the fair market value of the purchased assets, the parties are bound by such agreement unless the IRS determines that the agreement is inappropriate. Treas Reg §1.1060-1(c)(4).

A determination of whether goodwill or going concern value attaches to the group of assets is based on all the facts and circumstances surrounding the transaction. Treas Reg §1.1060-1(b)(2)(iii). Factors to be considered include the presence of: (1) any intangible assets (provided, however, that the transfer of an intangible asset in the absence of other assets will not be a transfer of a trade or business for purposes of §1060); (2) any excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and (3) any related transactions, such as lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer. Treas Reg §1.1060-1(b)(2)(iii).

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§10.20 c. IRC §197: Amortization of Intangibles

Intangible property acquired in a taxable asset sale generally can be amortized under IRC §197. The amount of the deduction is determined by amortizing the adjusted basis of the intangible ratably over a 15-year period beginning with the month in which the intangible was acquired. IRC §197(a). No other depreciation or amortization is permitted with respect to a §197 intangible. IRC §197(b). Note that if the intangible asset is instead licensed, royalty payments can be deducted.

A taxpayer is entitled to an amortization deduction with respect to any amortizable §197 intangible. IRC §197(a). The term "amortizable section 197 intangible" means any §197 intangible that is acquired by the taxpayer after the date of the enactment of §197 and that is held in connection with the conduct of a trade or business or an activity performed: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. IRC §§197(c)(1), 212. The term "amortizable section 197 intangible" does not include certain self-created intangibles, unless the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. IRC §197(c)(2). The exception for self-created intangibles does not apply to licenses, permits, and other rights granted by the government; covenants not to compete; and franchises, trademarks, or trade names. Treas Reg §1.197-2(d)(2)(iii).

Under §197(d), a "section 197 intangible" includes goodwill, going concern value, workforce in place, customer lists, business books and records, patents, copyrights, formulas, processes, designs, patterns, know-how, franchises, trademarks, and trade names. Certain types of property are excluded from the definition of a §197 intangible under §197(e), including (1) any interests in corporations, partnerships, trusts, or estates; (2) any interest under an existing futures contract, foreign currency contract, or other similar financial contract; (3) interests in land; (4) computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and other computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof; (5) interests under existing tangible property leases; (6) interests under certain existing indebtedness; (7) sports franchises and related items for franchises and property acquired on or before October 22, 2004 (see former IRC §197(e)(6) before amendment by the American Jobs Creation Act of 2004 (Pub L 108-357)); and (7) certain transaction costs. IRC §197(e).

Importantly, if a taxpayer disposes of any amortizable §197 intangible acquired in a transaction or series of related transactions and the taxpayer retains one or more other amortizable §197 intangibles acquired in that transaction or series of related transactions, no loss is recognized on the disposition. IRC §197(f)(1)(A). The adjusted basis of each of the retained intangibles is increased by the product of: (1) the loss that was not recognized solely by reason of this rule; and (2) a fraction, the numerator of which is the adjusted basis of the retained intangible on the date of the disposition and the denominator of which is the total adjusted bases of all the retained intangibles on that date. Treas Reg §1.197-2(g)(1)(i)(A).

If a §197 intangible is transferred in a nonrecognition transaction, the transfer is disregarded in determining (1) whether (with respect to the intangible's basis in the hands of the transferee to the extent not exceeding its basis in the hands of the transferor) the intangible is an amortizable §197 intangible; and (2) the amount of the deduction under §197 with respect to that basis. Treas Reg §1.197-2(g)(2)(ii)(A). Nonrecognition transactions are: (1) any transaction described in IRC §332, §351, §361, §721, or §731; and (2) any transaction between corporations that are members of the same consolidated group immediately after the transaction. Treas Reg §1.197-2(g)(2)(ii)(C).

If the intangible was acquired in a nonrecognition transaction (*i.e.*, a transaction in which all or part of the gain or loss was not recognized), the transferee generally steps into the shoes of the transferor with respect to the amount of the adjusted basis of the intangible in the transferee's hands that does not exceed its adjusted basis in the hands of the transferor. Treas Reg §1.197-2(g)(2)(ii)(B). If the transferor did not amortize the intangible, the transferee will not be allowed to amortize it. If, however, the transferee recognizes gain in the transaction that causes the transferee's basis in the intangible to be increased, the transferee will generally be allowed to amortize the intangible to the extent of the increase. Treas Reg §1.197-2(g)(2)(ii)(B).

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§10.21 d. State Sales Tax Issues

In certain states (including California), sales tax does not apply to the sale of intangible property that is transferred electronically. In the asset purchase agreement, the assets sold should be described with a reasonable value accorded each item. Taxpayers are well advised to separate tangible and intangible items in the transfer agreement, because, *e.g.,* in California, the amount paid for intangible personal property in a technology transfer agreement is not taxed if the transfer agreement separately states a reasonable price for the tangible personal property and the intangible items are transferred electronically. Rev & T C §6011(c)(10)(A). For example, one provision in the transfer agreement could address the transfer of copyrights, trademarks, trade secrets, patents, and other intellectual property rights (valued high), while a separate provision could address the transfer of manuals, designs, schematics, drawings, and copies of diskettes, tapes, and CD-ROMs (valued low).

California law states that if the technology transfer agreement does not separately state a price for the tangible personal property, and the tangible personal property or similar tangible personal property has been previously sold or leased (or offered for sale or lease) to third parties at a separate price, the price at which the tangible personal property was sold, leased, or offered to third parties will be used to establish the retail fair market value of the tangible personal property in order to determine the amount of the purchase price subject to tax. The remaining amount charged under the technology transfer agreement will be considered as received for the intangible personal property and will generally not be subject to tax. Rev & T C §6011(c)(10)(B).

If the technology transfer agreement does not separately state a price for the tangible personal property, and the tangible personal property has not been previously sold or leased (or offered for sale or lease) to third parties at a separate price, the retail fair market value will be deemed to equal 200 percent of the cost of materials and labor used to produce the tangible personal property subject to tax. Again, the remaining amount charged under the agreement will be considered to be received for the intangible personal property. Rev & T C §6011(c)(10)(C).

NOTE: Special rules apply with regard to the transfers of computers, software programs, and data processing. See 18 Cal Code Regs §1502.

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C. Taxable Stock Acquisitions

§10.22 1. General Tax Considerations

In a taxable stock sale, a shareholder will recognize gain or loss on the sale of the target company's stock in an amount equal to the difference between the shareholder's amount realized (cash plus the fair market value of any other property received) and the shareholder's adjusted basis in the target's stock. IRC §1001(a). Unless an IRC §338 election is made, the target company's assets retain their historical basis (referred to as "inside basis"), and the purchaser will not get a step-up in the basis of the target company's assets. If the target company developed its own intellectual property, it is likely that the target has no or minimal inside basis.

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2. IRC §338 Election: Domestic Context

§10.23 a. Generally

Internal Revenue Code §338 allows a purchasing corporation to treat a purchase of target company stock as a purchase of the target's assets. The target is treated as if it were two corporations: "Old T" and "New T." Treas Reg §1.338-1(a). Old T is generally treated as selling its assets to New T on the acquisition date. New T is treated as purchasing the assets from Old T for the amount that the purchaser paid for the target's stock (plus adjustments, including adjustments for the target's liabilities). Treas Reg §1.338-1(a). There are two types of elections possible under IRC §338: the IRC §338(g) election (also referred to as a "regular §338 election") and the IRC §338(h)(10) election. See §§10.24-10.25.

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§10.24 b. Regular IRC §338 Election

The regular §338 election can only be made by corporations. IRC §338(d); Treas Reg §1.338-3(b). The election must be made by the 15th day of the 9th month following the acquisition date. IRC §338(g). The purchaser is eligible to make a regular §338 election only if it made a qualified stock purchase ("QSP"). A QSP is a purchase of 80 percent of the target company's stock (by vote and value) during a 12-month "acquisition period." IRC §338(d)(3). The acquisition period refers to the 12-month period beginning with the date of the first acquisition by purchase of stock included in the QSP. IRC §338(g), (h)(1).

A "purchase" is any acquisition of stock, except the following (IRC §338(h)(3)):

- Acquisitions in which the purchaser gets a carryover basis;
- Acquisitions in which the purchaser gets a basis under IRC §1014(a) (property acquired from a decedent);
- Acquisitions that qualify as an exchange to which IRC §351, §354, §355, or §356 applies; and
- Acquisitions from a related person (*i.e.*, a person to whom the stock would be attributed under IRC §318(a) (except for §318(a)(4), dealing with options)).

Thus, a purchase usually means a taxable purchase of stock from an unrelated person.

NOTE: Redemptions of target company stock from persons unrelated to the buyer reduce the amount of outstanding stock for purposes of meeting the 80-percent requirement. Treas Reg §1.338-3(b)(5)(ii).

If a regular §338 election is made, two levels of tax ordinarily result. The target company shareholders are taxed on the gain or loss on the sale of their shares. In addition, the target company itself is taxed on the gain or loss on the deemed sale of its assets. Because of this double layer of tax, it is not common for companies to make a regular §338 election. If, however, the target company has net operating losses that could offset the gain on the asset sale, a regular §338 election might be advantageous because the double layer of tax would be eliminated.

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§10.25 c. IRC §338(h)(10) Election

Unlike the regular IRC §338 election (see §10.24), if the target company and the purchaser both agree to make a §338(h)(10) election, the target (Old T) is deemed to have sold all its assets while a member of the selling group to a new corporation (New T) in exchange for the sale proceeds, and Old T is considered to have distributed the sale proceeds to the selling shareholders in a complete liquidation. IRC §338(h)(10)(A). Importantly, a §338(h)(10) election will normally result in only one level of tax (on the deemed asset sale) because the liquidating distribution usually qualifies for tax-free treatment under IRC §§332 and 337. See Treas Reg §1.338(h)(10)-1(d)(4)(i), (5)(i). In addition, if a §338(h)(10) election is made, the selling shareholder will not recognize gain or loss on the sale of target company stock because the transaction is treated as an asset sale from Old T to New T rather than as a stock sale. See IRC §338(h)(10)(A); Treas Reg §1.338(h)(10)-1(d)(5)(iii).

NOTE: A §338(h)(10) election is often made when a stock sale is preferable for business reasons, but an asset sale is desired for tax reasons.

The §338(h)(10) election is available for a domestic target company that is a member of an affiliated group (under an 80-percent ownership test), but is not available for a common parent of a consolidated group. Treas Reg §1.338(h)(10)-1(b)(1). The affiliated group need not file a consolidated return. Treas Reg §1.338(h)(10)-1(b)(3). The §338(h)(10) election is also available for S corporations. Treas Reg §1.338(h)(10)-1(c)(1). A §338(h)(10) election will not result in deemed §338(h)(10) elections for the target company's affiliates. It will, however, result in a qualified stock purchase, so a §338(h)(10) election can be made for the target's 80-percent-owned subsidiaries.

New T remains liable for the tax liabilities of Old T (including tax liabilities arising from the deemed asset sale). These liabilities include tax liabilities for other members of the consolidated group for the period when the target company was a member of the group. Treas Reg §1.338(h)(10)-1(d)(2). Any net operating losses (NOLs) of the selling consolidated group (including the target's NOLs) are available to offset the gain on the sale because the target company is treated as being sold while still a member of the group.

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§10.26 d. Consistency Rules Under IRC §338(e)-(f)

Consistency rules are provided in the Internal Revenue Code (see IRC §338(e)-(f)) and Regulations to prevent a purchaser from stepping up the basis of acquired assets selectively. Treas Reg §1.338-8. The consistency rules generally apply if the purchasing corporation acquires an asset directly from the target company during the target's consistency period and the target is a subsidiary in a consolidated group. Treas Reg §1.338-8(a)(2). The consistency period is generally the period consisting of (1) the 1-year period before the beginning of the 12-month acquisition period for the target corporation, (2) the acquisition period (up to and including the acquisition date), and (3) the 1-year period beginning on the day after the acquisition date. IRC §338(h)(4)(A); Treas Reg §1.338-2(c)(5).

When the asset consistency rules apply, gain from the sale of the asset is reflected in the basis of the target company's stock under the investment adjustment provisions of the consolidated return regulations and may reduce gain from the sale of the stock. Treas Reg §1.338-8(a)(2). See Treas Reg §1.1502-32 (investment adjustment provisions). Under the consistency rules, the purchasing corporation generally takes a carryover basis in the asset, unless a §338 election is made for the target. See Treas Reg §1.338-8(a)(3), (f). Similar rules apply if the purchasing corporation acquires an asset directly from a lower-tier target company affiliate if gain from the sale is reflected in the basis of the target's stock under the investment adjustment provisions. Treas Reg §1.338-8(a)(2).

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§10.27 3. IRC §338(h)(10): Special S Corporation Considerations

If the target company is an S corporation with low-basis intangible property, the IRC §338(h)(10) election may be of substantial benefit to the purchaser because the purchaser might then be able to amortize the full cost of purchasing the intangible property ratably over 15 years. IRC §197. See §10.20.

If the §338(h)(10) election is made, the old target S corporation is deemed to have sold all its assets to the new target and distributed the proceeds to the selling shareholders in a complete liquidation. IRC §338(h)(10)(A). Under IRC §1366, the gain on the deemed asset sale flows through to the selling shareholders. If the target company is an S corporation, it is generally only subject to corporate-level tax if it had previously been a C corporation. IRC §1374. As a result, each selling shareholder recognizes ordinary or capital gains or losses. See Treas Reg §1.338(h)(10)-1(e). The selling shareholders are considered for tax purposes to have received the deemed liquidation distribution amount as full payment for their stock. Because the selling shareholders increase their basis in the target company's stock on the deemed asset sale, no double taxation should result on the deemed liquidation, because the distribution merely reduces the basis in the target company's stock unless IRC §1374 is applicable. The selling shareholders recognize no gain or loss on the sale of their stock. Treas Reg §1.338(h)(10)-1(d)(5)(iii).

The purchaser will generally benefit from a §338(h)(10) election. The selling shareholders, however, might be reluctant to agree to the election, even though they would generally not recognize double taxation on the sale, because they may recognize ordinary income by making the election. In contrast, if no election is made, the shareholders would generally only recognize capital gain from the sale of their stock. Ordinary income treatment could result because the transaction is treated as an asset sale and a deemed liquidation rather than solely a stock sale. Additional considerations, such as state tax implications or a preference for installment method treatment, should be evaluated.

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§10.28 4. IRC §338: California State Income Tax Issues

California has effectively adopted its own version of IRC §338. Corporations may elect IRC §338(g) or IRC §338(h)(10) treatment for California income tax purposes, even if no §338(g) or §338(h)(10) election is made for federal income tax purposes. See Rev & T C §23051.5.

If a §338(h)(10) election is made for California income tax purposes, the target company will be treated as if it sold its assets in a tax year ending on the date of the sale and then liquidated into the selling parent. If the target and the seller file a combined return, the income from the sale will be reported on that return. If the target and the seller do not file a combined return, the income will be reported on a separate return of the target. In either case, the liquidation of the target into the seller should be tax-free and the seller should not recognize gain on sale of the target's stock because of the application of §338(h)(10). See Rev & T C §23051.5(e); FTB Chief Counsel Ruling CI-88-254 (Nov. 15, 1988).

If the federal election is made, a §338(h)(10) election for California income tax purposes will not occur if both the buyer and seller agree not to make a California §338(h)(10) election. Likewise, if a buyer and seller did not make a federal §338(h)(10) election, a California §338(h)(10) election can be made if both the buyer and seller agree to make the state-level election (a separate election must be filed with the Franchise Tax Board). In deciding whether to make a §338(h)(10) election for California income tax purposes, taxpayers should determine the amount and the nature of the taxable gain that would be recognized if a §338(h)(10) election is made and if it is not made. Taxpayers should be aware that at the state level, unlike the federal consolidated return rules, a parent company does not adjust the basis of a subsidiary's stock to reflect investments by the parent under either combined or separate reporting. Thus, a §338(h)(10) election may cause more or less gain to be recognized than a straight stock sale, depending on the particular case. In addition, taxpayers need to consider the effect of the election on the sales factor of the apportionment formula for state income tax purposes.

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5. IRC §338: International Issues

§10.29 a. Generally

If the target company is a foreign corporation, it might be beneficial for the purchaser to make an IRC §338 election. If the foreign target has no U.S. shareholders and neither the target nor its shareholders are engaged in a U.S. trade or business, there should be no U.S. tax consequences to the §338 election. If the target has U.S. shareholders, there should still only be one level of tax as a result of the §338 election, because the foreign corporation's deemed asset sale arising from the §338 election should not result in U.S. taxation (assuming the foreign corporation is not engaged in a U.S. trade or business). A U.S. seller will generally be concerned with the amount and character of gain or loss and the ability to use foreign tax credits in connection with the sale of a controlled foreign corporation.

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§10.30 b. IRC §1248 Issues

Internal Revenue Code §1248 applies to the sale of stock of a controlled foreign corporation (CFC). If applicable, any capital gain will be treated as dividend income. IRC §1248; Treas Reg §1.1248-1(a)(1). If the seller is a corporation, however, it should be eligible for the foreign tax credit. IRC §902.

Internal Revenue Code §338 does not apply to determine the source or character of any item for purposes of the foreign tax credit. IRC §338(h)(16). In contrast, §338 does apply for purposes of determining the source or character of gain includible in income as a dividend under §1248, determined without regard to any deemed sale of assets under §338 by a foreign corporation. IRC §338(h)(16). Therefore, a deemed sale of assets through a §338 election is not allowed to change what would be foreign source passive income (from the sale of stock) to general limitation income (from a deemed sale of assets). General limitation income is defined generally as income that is not categorized as passive income. IRC §904(d)(2)(A)(ii). The rationale is to prevent a §338 election for a controlled foreign corporation (CFC) target from increasing the amount of general limitation earnings generated by the sale of the CFC's stock.

EXAMPLE: S owns all the stock of a CFC, with a zero basis and a $160 fair market value (FMV). CFC has $100 of general limitation accumulated earnings and profits (E&P) through the end of the taxable year. CFC has a $100 basis in its assets, which have an FMV of $160. If CFC sold its assets, the sale would produce general limitation income. P buys the stock of CFC from S on the last day of the taxable year for $160. P makes a §338 election. CFC is treated as selling its assets for $160, so its E&P increases to $160. Under IRC §338(h)(16), $100 of gain is dividend income under IRC §1248 and will be the general limitation for foreign tax credit purposes; $60 of gain is also dividend income under §1248, but is treated as stock gain for source and foreign tax credit purposes. Thus, the $60 is treated in the same way as it would have been absent a §338 election.

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§10.31 c. Subpart F Issues

As long as the gains from a deemed sale of a foreign corporation's assets through a §338 election are not effectively connected with a U.S. trade or business, they will not be subject to U.S. tax at the foreign corporate level. However, subpart F (IRC §§951-965) income can result from the foreign target's deemed sale of its assets. Under the subpart F rules, a 10-percent U.S. shareholder of a CFC is required to include in income as a dividend its pro rata share of the CFC's subpart F income. IRC §951(a)-(b).

Subpart F income includes foreign personal holding company income (FPHCI), which includes dividends, interest, rents, royalties, and gains from the sale of stock or from property that generates dividends, interest, rents, or royalties. IRC §954(c)(1). Therefore, if the U.S. seller has a subpart F inclusion arising from the deemed sale of a CFC target's assets, the subpart F inclusion could be passive income for foreign tax credit limitation purposes. IRC §904(d)(2), (3)(B). See also IRC §954(c)(1)(B) (gains from sale of property that produces passive income is FPHCI). As such, subpart F inclusions resulting from the deemed sale of a CFC target's assets can affect the FTC treatment of the U.S. seller's CFC stock gain because the passive income might not be sheltered by FTCs.

In addition, a subpart F inclusion will cause an increase in the basis of the CFC stock under IRC §961. As a result, any gain on the stock sale that might otherwise be treated as general limitation income in the form of a §1248 dividend would be reduced.

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§10.31A 6. Section 336(e) Election

Internal Revenue Code §336(e) provides that, under regulations prescribed by the Secretary, if a corporation that owns 80 percent of the stock in another corporation sells, exchanges, or distributes all of that stock, the corporation may elect to treat the sale, exchange, or distribution as a disposition of all of the assets of the other corporation, and no gain or loss will be recognized on the sale, exchange, or distribution. Internal Revenue Code §336(e) operates in a manner similar to IRC §338(h)(10), at least in the context of a stock sale.

The IRS has proposed regulations providing that the results of an IRC §336(e) election should coincide with those of an IRC §338(h)(10) election. See Prop Treas Regs §§1.336-1—1.336-5, 73 Fed Reg 49965 (2008). Internal Revenue Code §338(h)(10) requires that the target corporation be either an S corporation or a member of the U.S. selling consolidated group. An election under IRC §336(e) would require only that the target be owned at least 80 percent by a domestic corporation. The preamble to the regulations states that the regulations do not apply to transactions in which either the seller or the target is a foreign corporation. The regulations will not be effective until they are finalized.

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D. Nontaxable Asset or Stock Acquisitions

§10.32 1. Tax Consequences

If the acquiring company obtains the target company's assets in a reorganization, the acquirer takes a carryover basis in the target's assets, increased by the amount of gain that the target recognized on the transfer. IRC §362(b). If the acquiring company obtains the target company's stock in a reorganization, the acquirer generally takes a carryover basis in the target stock received equal to the basis that the target company's former shareholders had in their stock, increased by any gain recognized by the transferors. IRC §362(b). No step-up in the basis of the target's assets results. In a reverse subsidiary merger, the acquiring company generally takes a basis for its target company stock equal to the target's net asset basis (*i.e.*, the target's basis in its assets minus its liabilities). Treas Reg §1.358-6(c).

The target company recognizes no gain or loss if the transaction qualifies as a reorganization and the target distributes any "boot" received (*i.e.*, any cash or other property received in the reorganization apart from stock or other securities of the acquiring company) to its shareholders or creditors in accordance with the plan of reorganization. IRC §361(b). The target also generally recognizes no gain or loss on the distribution to its shareholders or creditors of stock of the acquiring company. IRC §361(c).

Target company shareholders recognize no gain or loss on the receipt of the acquiring company stock. IRC §354(a). Gain is recognized, however, on the receipt of any boot; the gain is limited to the fair market value (FMV) of the boot received. IRC §356(a)(1). Under IRC §358, the target company shareholder's basis in any stock of the acquiring company is equal to the shareholder's basis in target stock surrendered, decreased by any money received, the FMV of any other boot received, and any loss recognized on the exchange, and increased by any gain recognized on the exchange. IRC §358(a)(1).

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2. Common Tax Issues

§10.33 a. "Substantially All" Test

For favorable tax treatment of certain reorganizations, the Internal Revenue Code requires the acquiring company to obtain substantially all of the target company's assets. For example, in addition to other conditions, a C reorganization under IRC §368(a)(1)(C) generally requires that the acquiring company receive, in exchange solely for all or a part of its voting stock, "substantially all of the properties" of the target corporation. A nondivisive D reorganization requires that the acquiring corporation receive "substantially all of the assets" of the target company. See IRC §368(a)(1)(D), (b)(1)(A). Similarly, forward and reverse subsidiary mergers also have "substantially all" requirements.

There is no statutory definition for the term "substantially all." In Rev Proc *77-37*, 1977-2 Cum Bull 568, for purposes of obtaining an advance ruling, the IRS stated that the "substantially all" requirement of IRC §§354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) is satisfied if there is a transfer (and in the case of a surviving corporation under §368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer. Rev Proc *77-37*, 1977-2 Cum Bull 568. To the extent that the numerical guidelines are not satisfied in a particular transfer, the relevant facts and circumstances of the transfer (including the nature of the property that is transferred or retained) should direct the "substantially all" analysis.

EXAMPLE: In Rev Rul 57-518, ruling that "substantially all" of the target company's assets were transferred, the IRS stated that "[a]mong the elements of importance that are to be considered in arriving at the conclusion are the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof." In the ruling, the target company transferred 70 percent of its assets to another corporation in a transaction intended to qualify as a C reorganization under §368(a)(1)(C). The target transferred (1) all of its fixed assets (plant and equipment) at net book values, (2) 97 percent of all its inventories at book values, and (3) insurance policies and other properties pertaining to the business. The properties retained by the target included cash, accounts receivable, notes, and 3 percent of its total inventory. The IRS found that no portion of the assets not transferred was retained by the transferor for its own continued use. The IRS also found that the assets retained were for the purpose of meeting liabilities, and that the retained assets at fair market value approximately equaled the amount of the liabilities. The IRS therefore ruled that the transfer constituted a C reorganization. Rev Rul 57-518, 1957-2 Cum Bull 253.

In addition, several courts have held that the "substantially all" test for purposes of §368 is a facts and circumstances test. In *Moffatt v Comm'r* (1964) 42 TC 558, 578, aff'd (9th Cir 1966) 363 F2d 262 (quoting *Smith v Comm'r* (1936) 34 BTA 702, 705), the Tax Court stated that "[w]hether the properties transferred constitute 'substantially all' is a matter to be determined from the facts and circumstances in each case rather than by the application of any particular percentage." See also Rev Rul 57-518, 1957-2 Cum Bull 253 (stating that what constitutes "substantially all of the properties" for purposes of IRC §368(a)(1)(C) "will depend upon the facts and circumstances in each case rather than upon any particular percentage"); *James Armour, Inc. v Comm'r* (1964) 43 TC 295, 308.

In examining the facts and circumstances of each case, courts usually focus on operating assets, rather than nonoperating or liquid assets such as cash (unless the latter constitutes a substantial part of the transferor corporation's operating assets), and the purpose of the retention. See *Swanson v United States* (9th Cir 1973) 479 F2d 539 (failure to transfer liquid assets did not satisfy "substantially all" requirement because those assets were essential operating assets of the corporation, representing working capital); see also *James Armour, Inc. v Comm'r, supra* ("substantially all" requirement met even though transferee transferred only 66 percent of its assets; all transferred assets were essential to business enterprise and retained assets were only cash and accounts receivables). "Operating assets" may be defined as those "necessary to operate the corporate business whether or not those assets would appear on a corporate balance sheet constructed according to generally accepted accounting principles.… [I]ntangible assets alone may constitute substantially all of the corporate assets." *Smothers v U.S.* (5th Cir 1981) 642 F2d 894, 900.

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§10.34 b. Drop-Down or Push-Up of Target's Assets

In some acquisitions, the acquiring company may receive certain assets that are subsequently transferred to a parent or subsidiary of the acquiring company. An issue arises whether an otherwise tax-free reorganization will be disqualified by the later transfer of assets to a related party. Under Treas Reg §1.368-2(k), a transaction otherwise qualifying as a reorganization under IRC §368(a) will not be disqualified as a result of a subsequent transfer of the assets or stock received if the continuity of business enterprise requirement is satisfied (see §10.36) and either: (1) with respect to distributions (Treas Reg §1.368-2(k)(1)(i)),

(A) the property distributed consists of— (*1*) Assets of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be,… (*2*) Stock of the acquired corporation, provided that such distribution(s) of stock do not cause the acquired corporation to cease to be a member of the qualified group (as defined in §1.368-1(d)(*4*)(ii); or (*3*) A combination thereof; and (B) The aggregate of such distributions does not consist of— (*1*) An amount of assets of the acquired corporation, the acquiring corporation (disregarding assets held prior to the potential reorganization), or the surviving corporation (disregarding assets of the merged corporation), as the case may be, that would result in a liquidation of such corporation for Federal income tax purposes; or (*2*i) All of the stock of the acquired corporation that was acquired in the transaction[;]

or (2) with respect to transfers other than distributions (Treas Reg §1.368-2(k)(1)(ii)),

(A) The transfer(s) do not consist of one or more distributions to shareholders; (B) the property transferred consists of— (*1*) Part or all of the assets of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be; (*2*) Part or all of the stock of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, provided that such transfer(s) of stock do not cause such corporation to cease to be a member of the qualified group (as defined in §1.368-1(d)(*4*)(ii)); or (*3*) A combination thereof; and (C) The acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, does not terminate its corporate existence for Federal income tax purposes in connection with the transfer(s).

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§10.35 c. "Substituted Asset" Rationale

In Rev Rul 88-48, the IRS considered whether a transfer in which the transferor corporation (X) sold 50 percent of its historic assets to unrelated parties for cash and immediately afterwards transferred all of its assets (including the cash from the sale) to an acquiring corporation (Y) would meet the "substantially all" requirement of IRC §368(a)(1)(C). Although X transferred 50 percent of its historic assets in the prior sale, the sale proceeds were not retained by X or its shareholders, but were transferred to Y. Moreover, the prior sale of the historic assets was to unrelated purchasers, and the X shareholders retained no interest, direct or indirect, in those assets. The IRS therefore ruled that the "substantially all" requirement of §368(a)(1)(C) was met, because all of X's assets were transferred to Y. In the ruling, the IRS did not mention the continuity of business enterprise requirement (see §10.36), although the facts of the ruling indicate that that requirement would have been met. Rev Rul 88-48, 1988-1 Cum Bull 117. In addition, in IRS Letter Ruling 8839060 the IRS ruled that, for purposes of the "substantially all" requirement in a reverse subsidiary merger, cash received by a target company from the sale of its subsidiary would be considered "substituted assets."

Based on these authorities, the "substituted asset" rationale should protect dispositions made by the acquiring company as well as those made by the target. This rationale should also permit the target or the acquirer to lend, lease, or license a portion of the target's properties as part of the reorganization plan without violating the "substantially all" requirement. Caution should be exercised, however, if the person borrowing, leasing, or licensing the properties is related to any former target company shareholders.

NOTE: A downstream lending, lease, or license of a substantial portion of the target company's assets to a noncontrolled subsidiary might be questioned in light of the specific parameters of IRC §368(a)(2)(C). An upstream lending, lease, or license of a substantial portion of the target's assets to a shareholder of the acquiring company could raise a question of whether the acquiring company is actually the "acquiring" entity for C reorganization purposes.

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§10.36 d. Continuity of Business Enterprise

A transaction must satisfy the continuity of business enterprise (COBE) requirement to qualify as a tax-free reorganization under IRC §368(a). Treas Reg §1.368-1(d). In general, COBE requires that the acquiring corporation (P) (see Treas Reg §1.368-1(b)) either (1) continue the target corporation's historic business or (2) use a significant portion of the target's historic business assets in a business. The application of this general rule depends on all facts and circumstances. Treas Reg §1.368-1(d)(1) provides that "[t]he policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations." See also Rev Proc 83-81, 1983-2 Cum Bull 598.

The COBE requirement is satisfied if P continues T's historic business (known as "business continuity"). Treas Reg §1.368-1(d)(2). Alternatively, the COBE requirement is satisfied if P uses a significant portion of T's historic business assets in a business (known as "asset continuity"). Treas Reg §1.368-1(d)(3). Under the qualified group rule, the acquiring corporation is treated as holding all of the businesses and assets of each member in its qualified group. A "qualified group" is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of §368(c) in at least one other corporation, and stock meeting the requirements of §368(c) in each of the corporations (except the issuing corporation) is owned directly or indirectly by one or more of the other corporations. Treas Reg §1.368-1(d)(4)(i)-(ii).

For partnerships, each partner will be treated as owning the T business assets used in a business of the partnership in accordance with that partner's interest in the partnership. The acquiring corporation will be treated as conducting a business of a partnership if (1) members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business, or (2) one or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business. Treas Reg §1.368-1(d)(4)(iii)(A)-(B). If a significant historic T business is conducted in a partnership, the fact that P is treated as conducting that T business in accordance with the above rule tends to establish the requisite continuity, but is not alone sufficient. Treas Reg §1.368-1(d)(4)(iii)(C).

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E. Transfers to Controlled Corporations and Partnerships

§10.37 1. IRC §351: Contribution of Intangible Assets to Corporation

Under IRC §351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in that corporation, and immediately after the exchange that person or persons are in control of the corporation. "Control" is defined as the ownership of stock possessing at least 80 percent of the total voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes. IRC §368(c). If these requirements are not met, the transferor will recognize gain to the extent the value of the stock received exceeds the adjusted basis in the property transferred. An issue that arises with the transfer of intellectual property or rights to intellectual property is whether the transfer constitutes a transfer of "property" for purposes of IRC §351.

Section 351 does not define the word "property." Courts have broadly interpreted the term "property," stating in one case that it "encompasses whatever may be transferred." *U.S. v Stafford* (11th Cir 1984) 727 F2d 1043, 1052. In *E.I. du Pont de Nemours & Co. v U.S.* (Ct Cl 1973) 471 F2d 1211, the Court of Claims held that a nonexclusive patent license was §351 property. The IRS has also held that patents, copyrights, trademarks, and trade names constitute property for purposes of §351 regardless of whether the intangibles were created by the transferor. Rev Rul 69-156, 1969-1 Cum Bull 101 (grant of patent rights to corporation normally constitutes transfer of property); Rev Rul 79-288, 1979-2 Cum Bull 139 (transfer of corporate name and goodwill was property for purposes of §351). In addition, know-how and trade secrets constitute property for purposes of §351. See Rev Rul 71-564, 1971-2 Cum Bull 179 (unqualified transfer of exclusive right to use trade secret until it becomes public knowledge and no longer protectible under laws of country where transferee operates is property for purposes of §351).

The IRS and the courts have taken contrary views regarding the extent to which rights must be transferred in order for the transfer to constitute a "transfer of property" for purposes of §351. The IRS has generally adopted the view that a sale or exchange of the intellectual property is required for a transfer to constitute a "transfer of property" for purposes of §351. Under this view, an exclusive, unqualified right in perpetuity must ordinarily be granted to the transferee. For instance, in Rev Rul 64-56, 1964-1 Cum Bull 133, the IRS stated that all substantial rights to the property must be transferred for a transaction to be treated as a §351 transfer of property. The IRS stated that this requirement is satisfied if the transferor transfers an unqualified exclusive right in perpetuity to use a secret process or other similar secret information qualifying as property within all the territory of a country. In Rev Rul 69-156, 1969-1 Cum Bull 101, the IRS stated that a grant of patent rights constitutes a transfer of property within the meaning of §351 only if the grant of those rights would constitute a sale or exchange of property rather than a license for purposes of determining gain or loss. To constitute a sale or exchange, the grant must consist of all substantial rights to the patent. Rev Rul 69-156, 1969-1 Cum Bull 101.

EXAMPLE: In Rev Rul 69-156, a domestic corporation granted patent rights in a chemical compound to its foreign subsidiary in exchange for the subsidiary's stock. The patent rights gave the subsidiary the exclusive right to employ the patent in the country in which it was organized and operated, but the subsidiary agreed not to assert its right against the transferor or its other subsidiaries. The IRS held that the grant of the patent rights did not constitute a transfer of property for purposes of §351 because the subsidiary did not hold all substantial rights in the patent. Rev Rul 69-156, 1969-1 Cum Bull 101.

Courts, however, have rejected the sale or exchange concept and instead have examined whether the transfer of property has some value. In *H.B. Zachry Co.* (1967) 49 TC 73, the court held that the assignment of a carved-out oil payment, payable from the assignor's interest in certain oil and gas properties, constituted the transfer or property for purposes of §351. The court explained that unlike "the problem of capital gain versus ordinary income," §351 is "concerned solely with the historic exemption of transfers to a controlled corporation where the taxpayer interest in the property continues although the form of ownership is changed." In *E.I. du Pont de Nemours & Co. v U.S., supra,* the court held that a grant of a nonexclusive license on foreign patents was a transfer of property for purposes of §351. The court rejected the sale or exchange concept. Once it determined that the capital gains concept was irrelevant to whether a §351 transfer occurred, the court stated that it is not difficult to find that the nonexclusive license was property transferred. The court stated that the taxpayer handed over something of value and received stock in return.

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§10.38 2. IRC §721: Contributions to Partnerships

Under IRC §721, no gain or loss is recognized to a partnership or to any of its partners when property is contributed to the partnership in exchange for an interest in the partnership. The rules discussed above with respect to IRC §351 contributions of intangible assets should apply to partnerships. In *U.S. v Stafford* (11th Cir 1984) 727 F2d 1043, the court held that the taxpayer's contribution of a letter of intent outlining the major terms of a proposed loan and lease agreement was an "exchange" because the taxpayer owned it when he formed the partnership and had the right to transfer it to anyone he designated. The court noted that the letter gave the taxpayer or his designee very favorable financing terms for a hotel construction project. The fact that the letter was not enforceable under Georgia law did not necessarily preclude a finding that it was "property" under §721(a). The court determined that if the fact finder determined that the letter had value, then it was sufficient to constitute "property."

NOTE: In determining whether the letter of intent was property for §721 purposes, the court examined the authorities with respect to §351 transfers. *U.S. v Stafford, supra*.

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F. International Issues

§10.39 1. IRC §367(a)-(b): Special Considerations for International Nonrecognition Transactions

When a U.S. person transfers tangible property to a foreign entity in a transaction otherwise qualifying for nonrecognition under certain provisions of the Code (*e.g.,* IRC §332, §351, §354, §355, §356, or §361), the transfer may not necessarily be tax-free by operation of IRC §367(a). Internal Revenue Code §367(a)(1) provides generally that the transferee foreign corporation is not treated as a corporation for purposes of determining the extent to which gain is recognized (and therefore the transfer is potentially taxable) unless one of the exceptions set forth in IRC §367(a)(2)-(3) applies. The policy rationale underlying §367(a) is the federal government's desire to tax transfers of appreciated property that leaves the U.S. taxing jurisdiction.

Under IRC §367(a)(3) and Temp Treas Reg §1.367(a)-2T, IRC §367(a)(1) generally does not apply with respect to any tangible property transferred to a foreign corporation (and thus gain is not required to be recognized on the transfer) if the following two requirements are met:

- The property is transferred for use by the transferee foreign corporation in the active conduct of a trade or business outside of the U.S. (known as the "active trade or business" exception); and
- The U.S. person that transfers the property complies with the reporting requirements of IRC §6038B and its regulations.

The active trade or business test does not apply to intangible property transferred to a foreign corporation, unless it constitutes foreign goodwill or going concern value as defined in Temp Treas Reg §1.367(a)-1T(d)(5)(iii). See Temp Treas Reg §1.367(a)-5T. See §10.40 for discussion of the application of §367(d) to transfers of intangible property subject to IRC §351 or §361.

In August of 2008, proposed regulations were issued under IRC §367(a)(5). Internal Revenue Code §367(a)(5) provides that the exceptions to IRC §367(a)(1) in IRC §367(a)(2) (which provides that except as provided in regulations, IRC §367(a)(1) will not apply to the transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization) or IRC §367(a)(3) (the active trade or business test discussed above) will not apply in the case of a transfer of property by a domestic corporation to a foreign corporation in an exchange described in IRC §§367(a) or (b). Thus, under IRC §367(a)(5), the general rule is that the transfer of property by a U.S. transfer to a corporation in an IRC §361 exchange is subject to IRC §367(a)(1), which means that gain on the transfer is taxable. However, IRC §367(a)(5) also provides that subject to basis adjustments and other conditions the general rule of IRC §367(a)(5) will not apply (and as a result, the exceptions in IRC §367(a)(2) and (a)(3) will apply) if the U.S. transferor is controlled by five or fewer domestic corporations. The proposed regulations set forth rules applying IRC §367(a)(5) and provide an elective exception if certain conditions are met. See 73 Fed Reg 49278, 79280.

Under Treas Reg §1.367(a)-3, an outbound transfer (including direct and certain indirect transfers) of stock or securities in a domestic corporation by a U.S. person to a foreign corporation is considered a taxable exchange unless certain requirements are met. One requirement for a U.S. transferor who owns 5 percent or more of the stock of the foreign transferee immediately after the exchange is that the transferor enter into a gain recognition agreement with the IRS, under which the U.S. transferor pledges to recognize gain with respect to the transferred stock or securities in certain events. See generally IRC §367(a)(2); Treas Reg §1.367(a)-3(b)(1)(ii); Temp Treas Reg 1.367(a)-8.

Internal Revenue Code §367(b) applies to transfers between or among U.S.-controlled foreign entities. Under Treas Reg §1.367(b)-3, the repatriation of assets of a foreign corporation (referred to in the regulations as a "foreign acquired corporation") to a domestic corporation in the context of an IRC §332 liquidation or an asset acquisition under IRC §368(a)(1) results in the "exchanging shareholder" having income inclusion (as a deemed dividend) to the extent of the "all earnings and profits" amount with respect to its stock in the foreign acquired corporation. The "all earnings and profits" amount is generally all of the foreign corporation's net positive earnings and profits. An "exchanging shareholder" is a U.S. shareholder of the foreign acquired corporation (under a 10-percent-ownership test) or a foreign corporate shareholder of the foreign acquired corporation that is owned by a U.S. shareholder. Under Temp Treas Reg §1.367(b)-3T(b)(4)(i)(A), the exchanging shareholder may elect to recognize gain, but not loss, realized in the exchange if certain requirements are satisfied. If the election is made, Temp Treas Reg §1.367(b)-3T(b)(4)(i)(B) provides rules to reduce certain tax attributes of the foreign acquired corporation.

In the case of a U.S. person that is not a U.S. shareholder (*i.e.,* owns less than 10 percent of the foreign corporation's stock), under Treas Reg §1.367(b)-3(c), the U.S. person will recognize gain (rather than the all E&P amount), but not loss, with respect to the stock of the foreign acquired corporation. Treas Reg §1.367(b)-3(c)(1)-(2). An election is provided when the U.S. person

can elect to include the all earnings and profits amount. Treas Reg §1.367(b)-3(c)(3).

Treasury Regulation §1.367(b)-4 addresses the acquisition of the assets or stock of a foreign corporation by a foreign corporation in IRC §351 transactions and in certain reorganizations. This regulation requires an inclusion when, in connection with the transaction, controlled foreign corporation (CFC) or U.S. shareholder status is lost. The amount that the exchanging shareholder must include is equal to the amount that it would have included as a dividend under IRC §1248 had it sold the foreign acquired corporation in a taxable sale. The inclusion under §1248 is limited to the amount of gain realized by the exchanging shareholder in the transaction. Treas Reg §1.367(b)-4(b).

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Source: Business Law/Intellectual Property in Business Transactions/10 Federal Income Tax Issues/ 2. IRC §367(d): Special Rules for Transfers of Intangibles/§10.40 a. Generally

2. IRC §367(d): Special Rules for Transfers of Intangibles

§10.40 a. Generally

Internal Revenue Code §367(d) provides special rules for transfers of intangible property by a U.S. person to a foreign corporation in an exchange described in IRC §351 or §361. In general, such a transfer is treated as if the transferor sold the intangible property to the foreign corporation in exchange for deemed annual payments that are contingent on the productivity or use of the intangible property over the useful life of the property. IRC §367(d); Temp Treas Reg §1.367(d)-1T(c). Section 367(d) applies regardless of whether the property is to be used in the U.S. in connection with goods to be sold or consumed in the U.S., or in connection with a trade or business outside the U.S. Temp Treas Reg §1.367(d)-1T(b).

The useful life of intangible property for purposes of determining the period over which the §367(d) deemed annual payments must be made is the entire period during which the property has value, but in no event is the useful life of an item of intangible property considered to exceed 20 years. If intangible property derives its value from secrecy or from protections afforded by law, the useful life of such property terminates when the property is no longer secret or legally protected. Temp Treas Reg §1.367(d)-1T(c)(3). The appropriate arm's-length charge for purposes of determining the amount of the §367(d) deemed payment is determined in accordance with Treas Reg §1.482-4. Temp Treas Reg §1.367(d)-1T(c)(1).

If intangible property is transferred under an arrangement that covers more than 1 year, the consideration deemed paid by the transferee foreign corporation in each taxable year may be adjusted to ensure that it satisfies the commensurate-with-income standard. See §10.58. The periodic adjustment is determined under a facts and circumstances test. Treas Reg §1.482-4(f)(2)(i). Amounts included in the transferor's income under §367(d) are treated as ordinary income. IRC §367(d)(2)(C). Contingent payments from the sale or exchange of an intangible used outside of the U.S. are foreign source income. IRC §865(d).

Section 367(d)(1) defines "intangible property" by cross-reference to IRC §936(h)(3)(B). Section 936(h)(3)(B) defines intangible property as any of the following that have substantial value independent of the services of any individual: (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item.

The transfer of foreign goodwill or going concern value is not subject to §367(d). Temp Treas Reg §1.367(d)-1T(b). Foreign goodwill and going concern value are defined as the residual value of a business operation conducted outside of the U.S. after all other tangible and intangible assets have been identified and valued. The value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value for this purpose. Temp Treas Reg §1.367(a)-1T(d)(5)(iii). Nevertheless, the transfer of foreign goodwill or going concern value is still subject to the branch loss recapture rules set forth in Temp Treas Reg §1.367(a)-6T. Temp Treas Reg §1.367(a)-6T(c)(3). See §10.46.

With respect to the deemed annual payments, the U.S. transferor is required to annually include, over the useful life of the intangible property, an amount that represents an appropriate arm's-length charge for the use of the property. Temp Treas Reg §1.367(d)-1T(c)(1). The transferee foreign corporation generally is not able to realize a deduction in the country where it is a tax resident for any deemed royalty payment to the U.S. transferor. If the U.S. transferor enters into a formal license of the intangible property to the foreign corporation, however, the foreign corporation could presumably deduct the royalty payments.

If an actual sale or license is made, then §367(d) does not apply. Temp Treas Reg §1.367(d)-1T(g)(4)(i). If an adjustment under IRC §482 is required on account of an actual sale or license of intangible property, §367(d) does not apply with respect to the required adjustment. Temp Treas Reg §1.367(d)-1T(g)(4)(i). Instead, the following anti-abuse rule applies: If a U.S. person transfers intangible property to a related foreign corporation without consideration, or the terms of an actual sale or license differ so greatly from the economic substance of the transaction, the U.S. person is treated as having made a transfer of intangible property subject to §367(d). Temp Treas Reg §1.367(d)-1T(g)(4)(i)-(ii).

For transfers of intangible property to a partnership, IRC §721 gives the IRS authority to issue regulations. For instance, §721(c) provides that the Secretary may provide by regulations that §721(a) shall not apply to gain realized on the transfer of property to a partnership if that gain, when recognized, will be includible in the gross income of a person other than a United States person. No regulations under §721 have been issued as of this writing. In addition, §721(d) provides that "[f]or regulatory authority to treat intangibles transferred to a partnership as sold, see section 367(d)(3)." Section 367(d)(3) permits the Secretary to provide by regulations that the rules of §367(d)(2) also apply to the transfer of intangible property by a United States person to a partnership in circumstances consistent with the purposes of §367(d)(3). Regulations under §367(d)(3) have likewise not been

issued as of this writing.

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§10.41 b. Subsequent Stock Transfers to Unrelated Persons

If, within the useful life of the intangible property, the U.S. transferor disposes of the stock of the transferee foreign corporation to a person that is not a related person, the U.S. transferor is treated as having simultaneously sold the intangible property to the person acquiring the stock of the transferee foreign corporation. Temp Treas Reg §1.367(d)-1T(d)(1). See Temp Treas Reg §1.367(d)-1T(h) (defining "related person" and applying 10-percent-ownership test). The U.S. transferor is required to recognize gain (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the date of the original transfer). Temp Treas Reg §1.367(d)-1T(d)(1).

If the U.S. transferor's disposition of the stock of the transferee foreign corporation is subject to U.S. tax other than by reason of this rule, the amount of gain otherwise required to be recognized with respect to the stock of the transferee foreign corporation is reduced by the amount of gain recognized with respect to the intangible property. Temp Treas Reg §1.367(d)-1T(d)(1). See Temp Treas Reg §1.367(d)-1T(d)(2) (rules for basis and earnings and profits computations).

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§10.42 c. Subsequent Stock Transfers to Related Persons

If, within the useful life of the transferred intangible property, the U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related (see Temp Treas Reg §1.367(d)-1T(h)) to the U.S. transferor, then the following rules apply (Temp Treas Reg §1.367(d)-1T(e)(1)(i)-(ii)):

- Each related U.S. person is treated as having received a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor; and
- Each related U.S. person, over the useful life of the property, must annually include as ordinary income a proportionate share of the amount that would have been included in the income of the U.S. transferor.

Temporary Treas Reg §1.367(d)-1T(e)(1)(iii) sets forth the rules regarding reducing the amount of income required to be recognized by the U.S. transferor. Temporary Treas Reg §1.367(d)-1T(e)(2) specifies the adjustments (*e.g.,* basis and subpart F adjustments) that must be made when a U.S. person transfers stock of a transferee foreign corporation to a related person.

NOTE: The rules discussed above are reapplied in the case of any later transfer of the stock of the transferee foreign corporation by a related U.S. person that received such stock in a transfer. Temp Treas Reg §1.367(d)-1T(e)(1)(iv).

If a U.S. person transfers intangible property to a foreign corporation in an IRC §367(d) exchange, and within the useful life of the transferred intangible property the U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more foreign persons that are related (see Temp Treas Reg §1.367(d)-1T(h)) to the transferor, then the U.S. transferor must continue to include in its income the deemed payments in the same manner as if the subsequent transfer of stock had not occurred. This rule does not apply with respect to a subsequent transfer by the U.S. person of any of the remaining stock to any related U.S. person or unrelated person. Temp Treas Reg §1.367(d)-1T(e)(3).

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§10.43 d. Subsequent Dispositions of Intangible Property

Temporary Treas Reg §1.367(d)-1T(f)(1) provides that if a U.S. person transfers intangible property to a foreign corporation in an IRC §367(d) exchange, and within the useful life of the intangible property the transferee foreign corporation subsequently disposes of the intangible property to an unrelated person, the following rules apply:

- The U.S. transferor (see Temp Treas Reg §1.367(d)-1T(e)(1)) of the intangible property must recognize gain (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the original transfer); and

- The U.S. transferor must recognize a §367(d) deemed payment for that part of its taxable year during which the intangible property was held by the transferee foreign corporation, and thereafter is not required to recognize any further §367(d) deemed payments on account of the transferred intangible property disposed of by the transferee foreign corporation.

The requirement that a U.S. person recognize gain under Temp Treas Reg §1.367(d)-1T(c) (the deemed royalty payments) or (e) (transfers of the transferee foreign corporation's stock to a related person) is not affected by the transferee foreign corporation's subsequent disposition of the transferred intangible property to a related person. Temp Treas Reg §1.367(d)-1T(f)(3).

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§10.44 e. Deemed Sales Election

Temporary Treas Reg §1.367(d)-1T(g)(2) provides that a U.S. person that transfers intangible property to a foreign corporation in an IRC §367(d) exchange may elect to treat the transfer as a sale, and recognize ordinary income in the year of the transfer in an amount equal to the difference between the fair market value of the intangible property transferred and its adjusted basis, provided certain requirements are met. To make this election, one of the following must be true:

- The intangible property transferred must constitute an "operating intangible," defined as "any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of the property" (Temp Treas Reg §1.367(a)-1T(d)(5)(ii)); examples of operating intangibles include long-term purchase or supply contracts, surveys, studies, and customer lists;

- The transfer of the intangible property is either legally required by the government of the country in which the transferee corporation is organized as a condition of doing business in that country, or compelled by a genuine threat of immediate expropriation by the foreign government; or

- The following requirements are met (Temp Treas Reg §1.367(d)-1T(g)(2)(iii)):

- The U.S. person transferred the intangible property to the foreign corporation within 3 months of the organization of that corporation and as part of the original plan of capitalization of that corporation;

- Immediately after the transfer, the U.S. person owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation;

- Immediately after the transfer, at least 40 percent of the total voting power and total value of the stock of the transferee foreign corporation is owned by foreign persons unrelated to the U.S. persons;

- Intangible property constitutes at least 50 percent of the fair market value of the property transferred to the foreign corporation by the U.S. transferor; and

- The transferred intangible property will be used in the active conduct of a trade or business outside of the United States within the meaning of Temp Treas Reg §1.367(a)-2T and will not be used in connection with the manufacture or sale of products in or for use or consumption in the United States.

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§10.45 f. Anti-Abuse Rule

If a U.S. person transfers intangible property to a domestic corporation with a principal purpose of avoiding the effect of IRC §367(d) and its regulations and thereafter transfers the stock of that domestic corporation to a related foreign corporation, the U.S. person is treated as having transferred the intangible property directly to the foreign corporation, solely for purposes of §367(d). Temp Treas Reg §1.367(d)-1T(g)(6).

The U.S. person is presumed to have transferred intangible property for a principal purpose of avoiding the effect of §367(d) if the property is transferred to the domestic corporation within 2 years before the transfer of the domestic corporation's stock to the foreign corporation. The presumption may be rebutted by clear evidence that the subsequent transfer of the stock of the domestic transferee corporation was not contemplated at the time the intangible property was transferred to that corporation and that avoidance of §367(d) was not a principal purpose of the transaction. A transfer may have more than one principal purpose. Temp Treas Reg §1.367(d)-1T(g)(6).

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§10.46 3. Branch Loss Recapture Rule

When engaging in nontaxable transactions that involve a foreign target, taxpayers should keep in mind the branch loss recapture rule. Under this rule, the active foreign trade or business exception does not apply to a transfer of assets of a foreign branch to the extent that the taxpayer deducted the branch's net losses for U.S. tax purposes. See IRC §367(a)(3)(C); Temp Treas Reg §1.367(a)-6T. The branch loss recapture rule is generally designed to prevent the situation where a taxpayer (1) conducts foreign operations through a branch during an initial phase when the branch incurs losses that the taxpayer deducts for U.S. tax purposes, and then (2) incorporates the foreign branch when it turns profitable (and, absent the application of an antideferral provision, is able to defer U.S. tax on the foreign corporation's income).

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V. USE OF OFFSHORE ENTITIES

A. Importance of Sourcing

§10.47 1. Royalties Received by U.S. Citizens

The United States asserts taxing jurisdiction over the worldwide income of U.S. persons. Thus, it is generally irrelevant for purposes of U.S. tax jurisdiction whether a U.S. person derives income from activities carried out within the U.S. or outside the U.S. The U.S. simply taxes worldwide income of U.S. persons. As a result of the U.S. tax liability on worldwide income, a U.S. taxpayer's foreign source income is often subject to double taxation because both the U.S. and the foreign jurisdiction tax the same income. The foreign tax credit provisions (IRC §§901-908), however, are designed to eliminate (or, sometimes, only reduce) the impact of double taxation on a U.S. taxpayer's foreign source income.

One of the central roles of the source of income rules, as they apply to U.S. persons, is to regulate application of the foreign tax credit mechanisms set forth in the Internal Revenue Code. For example, IRC §901 permits a U.S. taxpayer to elect to claim, subject to the limitation mechanism set forth in IRC §904, a credit against the taxpayer's U.S. tax liability for foreign taxes paid. IRC §901(a). Internal Revenue Code §904 is deemed to limit a taxpayer's foreign tax credit to the amount of U.S. tax imposed against the taxpayer's foreign source taxable income. IRC §904(a). The §904 formula is based on the ratio of the taxpayer's foreign source taxable income to its worldwide taxable income. The limitation imposed by §904(a) is calculated using the following formula:

$$\frac{\textbf{Foreign Source Taxable Income}}{\textbf{Worldwide Taxable Income}} \times \text{Pre-credit U.S. Tax Liability} = \text{FTC Limitation}$$

Because of the way in which the §904 foreign tax credit limitation operates, much of the planning with respect to the foreign tax credit focuses on efforts to increase the foreign source portion of a taxpayer's worldwide taxable income.

The definition of "subpart F Income" (see IRC §§951-965) also implicates the source of income provisions. Under IRC §951(a), a U.S. shareholder of a controlled foreign corporation (CFC) is required to include in gross income its pro rata share of the CFC's subpart F income for the year. The term "subpart F income" is defined by reference to five subcategories of income. IRC §952(a). However, subpart F income does not include any U.S. source income of the CFC that is effectively connected with a U.S. trade or business, unless that income is exempt from tax or subject to a reduced rate of tax under a U.S. treaty obligation. IRC §952(b).

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2. Royalties Received by Foreign Persons

§10.48 a. Generally

The source of income provisions can also affect the calculation of U.S. tax liability for foreign individuals and foreign entities. Generally, the U.S. asserts its taxing jurisdiction over foreign individuals and entities based on income derived from the U.S., as well as any base of operations located in the U.S. (such as a permanent establishment, *i.e.,* a fixed operation within the U.S.). Foreign taxpayers are generally not subject to U.S. tax liability with respect to foreign source income. See IRC §§872(a), 882(b) (limiting definition of "gross income" to U.S. source income).

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§10.49 b. Withholding Tax on Certain U.S. Source Income

Internal Revenue Code §§871(a) (foreign individuals) and 881 (foreign corporations) impose a 30-percent withholding tax on foreign individuals and corporations with respect to certain U.S.-source fixed or determinable annual or periodical income (FDAPI) and other U.S.-source income, if that income is not income effectively connected with a U.S. trade or business (ECI). The withholding tax obligations set forth in IRC §§871 and 881 are subject to reduction or elimination by many U.S. treaty provisions.

The payor (a "withholding agent" under the regulations) of income to a foreign person that is potentially subject to taxation under §871(a) or §881 must be aware of these source of income provisions. The term "withholding agent" is defined as any person, U.S. or foreign, that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding. Treas Reg §1.1441-7(a)(1). If the income in question is subject to taxation under §871(a) or §881, the payor is generally required to withhold the tax under IRC §§1441-1442 and 1446. Failure to withhold when required to do so can be a costly mistake, because the ultimate liability for the withholding tax rests with the withholding agent. IRC §1461. See also Treas Reg §1.1461-1(a)(2). Under IRC §1463, if the tax on the U.S. source income of a foreign person is paid by the payee of the income, it is not collected again from the withholding agent. The withholding agent, however, will remain liable for any interest or penalties. See Treas Reg §1.1463-1(a). Nevertheless, withholding is generally not required with respect to foreign-source income.

Generally, unless a treaty applies, U.S.-source royalties paid to a foreign person from intangibles will be subject to a 30-percent withholding tax. See IRC §§871(a), 881(a); Treas Reg §1.1441-2(c)(2). In addition, unless a treaty applies, a foreign person's U.S.-source gain relating to contingent payments received from the sale or exchange of a patent, copyright, or similar intangible will be subject to a 30-percent withholding tax. Treas Reg §1.1441-2(c)(2).

NOTE: A payment is considered made to a person if that person realizes income, whether or not that income results from an actual transfer of cash or other property. A payment is also considered made when the amount would be includible in the income of the beneficial owner under U.S. tax principles governing the cash basis method of accounting. Treas Reg §1.1441-2(e)(1). Further, a payment is considered made to the extent income subject to withholding is allocated under §482. Treas Reg §1.1441-2(e)(2).

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§10.50 c. Effectively Connected Income

The source of income provisions also serve as a preliminary step to determine whether a foreign taxpayer has effectively connected income (ECI) with respect to a U.S. trade or business. Under IRC §§871(b) (foreign individuals) and 882 (foreign corporations), nonresident alien individuals and foreign corporations are subject to U.S. tax at the regular graduated rates of income tax on any income that is effectively connected with the conduct of a trade or business within the U.S. tax on ECI may be required to be withheld by the payor. See IRC §§1445 (withholding on dispositions of U.S. real property interests), 1446 (withholding on foreign partner's share of ECI). Generally, under IRC §864(c)(4), foreign-source income is not treated as ECI. Foreign-source royalties are treated as ECI only if (1) the foreign person has an office or other fixed place of business in the U.S., and (2) the royalty is for the use of or the privilege of using intangible property in the active conduct of a U.S. trade or business. IRC §864(c)(4)(B)(i).

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B. Royalty Sourcing Rules

§10.51 1. In General

The source of royalty income is determined based on the location where the property is used or where the licensee has the right to use the property (a situs-based rule). IRC §§861(a)(4), 862(a)(4). To the extent that income is derived from the licensing of intellectual property used in more than one location, that income must be allocated between sources. IRC §863. The place where the license was entered into, the place of payment, and the nationality or residence of the lessor and lessee are all irrelevant to the determination of the source of royalty income.

Internal Revenue Code §861(a)(4) provides that royalties derived from property located in the U.S. (or from any interest in such property), including royalties for the use of or privilege of using U.S. patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other property, constitute U.S. source income. Section 862(a)(4) further provides that royalty income derived from the use of property located outside the U.S. (or any fractional interest in such property) constitutes foreign-source income.

The source of income derived from the use, rental, license, or lease of intangible property is sourced where the licensee is legally entitled to use that property, provided that the property is actually put to use in that location. See Rev Rul 68-443, 1968-1 CB 304. It is important to remember that U.S. source royalties may be subject to a 30-percent withholding tax (subject to reduction by applicable treaty) if paid to a foreign person. See IRC §§871(a)(1), 881(a)(1); Treas Reg §1.1441-2(a).

EXAMPLE: Revenue Ruling 68-443, 1968-1 Cum Bull 304 illustrates the point that royalty income is sourced to the location of eventual use, and that the place where the right to use the property is transferred is not relevant to the sourcing of such income. Revenue Ruling 68-443 addressed a fact pattern in which X, a resident foreign corporation, owned a trademark for certain products in foreign countries. X entered into a licensing agreement with Y, a U.S. corporation, under which Y was licensed the right to place X's foreign trademark on Y's products and sell the products in foreign countries. An unrelated third party held the rights to the U.S. trademark. Under the terms of the licensing agreement, Y paid X a royalty based on a percentage of the initial sales price of the trademarked products. Y manufactured the trademarked products in the U.S., affixing the relevant trademarks to the property in question within the U.S., and then sold the items to foreign buyers in the U.S. for eventual resale and consumption in foreign countries. All right, title, and interest in the products passed to the foreign buyers within the U.S. Thus, the initial sale was regarded as having taken place in the U.S. At issue in Rev Rul 68-443 was whether the royalty payments made by Y to X under the licensing agreement constituted U.S. source income, given that the trademarks were affixed to the products in the U.S. and the underlying property was sold in the U.S. According to the IRS, the foreign trademark was considered "used" in the foreign country in which ultimate consumption would take place, because Y only had a right to use the affixed trademark in the foreign country. The trademark was therefore considered "used" in the foreign country where Y held the right to use it, and the royalty payments were therefore considered foreign-source income. The royalties paid by Y to X were paid for the use of the trademark in the foreign countries; the place of initial sale of the trademarked products was not the controlling factor in determining the source of income. Rev Rul 68-443, 1968-1 CB 304.

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§10.52 2. Back-to-Back Royalties

The royalty source rules can present a trap for the unwary. Back-to-back licensing transactions can raise potential withholding obligations for nonresident corporations, and are open to possible attack by taxing authorities under a substance-over-form approach. The IRS has looked through such arrangements to assert the application of U.S. withholding tax on payments made by non-U.S. persons. See Rev Rul 80-362, 1980-2 Cum Bull 160.

EXAMPLE: In Rev Rul 80-362, the IRS explored the application of U.S. withholding tax to royalty payments made by a foreign person to an unrelated foreign party. The facts involved A, a nonresident alien that resided in a country without an income tax treaty with the U.S. The U.S. rights to a patent were licensed by A to X, an unrelated Netherlands corporation. Under the terms of the license, X agreed to pay a fixed annual royalty to A. X relicensed the same U.S. patent rights to Y, an unrelated U.S. corporation, in exchange for a royalty based on the number of units produced utilizing the patent. The ruling assumed that X qualified for the reduced rate of withholding on royalty payments under the U.S.-Netherlands income tax treaty. According to the IRS, the royalty payment made by X to A constituted U.S. source royalty income. The IRS's position was based on the view that A's "use" of the patent took place in the U.S. The royalties paid by X to A therefore constituted U.S.-source income, and were therefore subject to U.S. withholding tax at the full statutory rate (the facts assumed that there was no income tax treaty between the U.S. and A's country of residence). The ruling concluded that under IRC §1441(a) (as then in effect), X was required to withhold, from the royalties payable to A, 30 percent of the gross amount of the royalty payments and remit that amount to the IRS.

The IRS's position outlined in Rev Rul 80-362 should not be interpreted as the definitive statement of the law concerning back-to-back royalty structures. For example, consider the Tax Court's holding in *SDI Netherlands B.V. v Comm'r* (1996) 107 TC 161. *SDI* involved a Netherlands corporation (SDI Netherlands) that was a member of an affiliated group of companies (SDI Group) that designed, manufactured, marketed, and serviced commercial systems software for IBM mainframe computers worldwide. SDI Netherlands entered into a licensing agreement with SDI Bermuda, another member of the SDI Group. In accordance with that license, SDI Bermuda granted SDI Netherlands the worldwide rights to use the IBM software in exchange for royalty payments ranging from 93 to 98 percent.

During the years 1987-1990, SDI Netherlands received $19.5 million in royalties from worldwide sources and paid SDI Bermuda $18.6 million in royalty payments under the license. SDI Netherlands had another licensing agreement with SDI USA, a wholly-owned U.S. subsidiary of SDI Netherlands, granting SDI USA the U.S. rights to the IBM software in exchange for royalty payments of 50 percent. During 1987-1990, SDI USA paid SDI Netherlands $10.8 million in royalties. The IRS issued a deficiency notice to SDI Netherlands for the years 1987-1990, determining a deficiency of $2.9 million and contending that SDI Netherlands was required under IRC §§881(a), 1441, and 1442 to withhold a 30-percent tax on the royalty payments it made to SDI Bermuda. The IRS asserted that those royalties were derived from the royalties paid by SDI USA to SDI Netherlands.

In ruling that the payments made by SDI USA to SDI Netherlands were separate from the payments made by SDI Netherlands to SDI Bermuda, the Tax Court emphasized: (1) that the two licensing agreements had "separate and distinct terms"; (2) that SDI Netherlands had an "independent role as the licensee from SDI Bermuda and the licensor of the other entities, including but not limited to SDI USA"; (3) that SDI Netherlands was compensated "for its efforts," as indicated by the spread in the royalty payment schedules; and (4) that SDI Netherlands realized substantial earnings from its licensing activities. 107 TC at 175. The Tax Court rejected the IRS's argument that, because the royalties paid by SDI USA to SDI Netherlands were U.S.-source income, the royalties retained the same character when SDI Netherlands paid a portion of them to SDI Bermuda. The court acknowledged that, although authority on this particular issue was "sparse," the instant case fell "within the ambit" of *Northern Indiana Pub. Serv. Co. v Comm'r* (1995) 105 TC 341, in which the court held that a foreign corporation was not a mere conduit of its U.S. parent. Finally, the Tax Court noted that the IRS had not argued that SDI Netherlands was a mere conduit or agent of SDI USA in paying royalties to SDI Bermuda, or that SDI Bermuda was the beneficial owner of the SDI USA royalty payments. The court distinguished cases such as *Aiken Indus. v Comm'r* (1971) 56 TC 925 and *Northern Indiana Pub. Serv. Co. v Comm'r, supra,* stating that the conduit concepts in those cases did not apply in the *SDI* case.

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§10.53 3. Apportionment Issues

It is often necessary to apportion royalties between different locations, *e.g.,* to distinguish between U.S. and foreign rights, as well as to allocate income between different foreign jurisdictions for purposes of applying U.S. income tax treaties. The regulations under IRC §§861(a)(4) and 862(a)(4) do not provide specific guidelines for apportioning income between different geographic locations. Nonetheless, it is clear that the courts will apportion royalties income between different geographic regions if there is a basis for the allocation. See *Molnar v Comm'r* (1946) 156 F2d 924. The allocation is generally determined based on a facts and circumstances analysis.

Intangible property presents unique apportionment issues. It is important to distinguish U.S.-source from foreign-source royalty payments when both foreign and domestic rights are being licensed. It is also important to document the basis of the allocation at the time the contract is executed. Cost sharing arrangements (see §§10.64-10.73) should specifically detail the rights owned by each of the contracting parties, and U.S. rights should usually be given to the U.S. party to avoid a U.S. withholding tax issue. See IRC §482; Treas Reg §1.482-7T.

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§10.54 C. Sales of Intangibles

Income derived from the sale of an intangible asset is generally sourced by the residence of the seller. IRC §865(a). This residency rule will not apply, however, to the extent that the payments from the sale are contingent on the productivity, use, or disposition of the intangible. IRC §865(d)(1)(A). To the extent that the payments in consideration for the sale of an intangible asset are contingent, the source of those payments is determined as if the contingent payments were royalties (*i.e.,* sourced based on place of use; see §10.51). IRC §865(d)(1)(B). Importantly, unless a treaty applies, a foreign seller's U.S. source gain relating to contingent payments received from the sale or exchange of a patent, copyright, or similar intangible will be subject to a 30-percent withholding tax. Treas Reg §1.1441-2(c)(2).

The sale of goodwill is subject to a special rule. To the extent that a payment for goodwill is not contingent on the productivity, use, or disposition of the goodwill, the consideration from the sale of the goodwill will be sourced to the country in which the goodwill was generated. Contingent payments made for goodwill are sourced under the royalty rules discussed in §§10.51-10.53. IRC §865(d)(3).

Under IRC §865(d)(4), a sale of intangible property that was subject to depreciation or amortization adjustments will be subject to the following coordination provisions: (1) to the extent that gain on the sale does not exceed the depreciation adjustments for the intangible property, the source of income rules set forth in IRC §865(c) (depreciable personal property) apply; and (2) the source of any gain in excess of any depreciation adjustments is characterized under the general source rules applicable to the sale of intangible property, discussed above. To the extent that any gain does not exceed depreciation adjustments, the gain is (1) U.S. source in the same proportion that the U.S. depreciation adjustments bear to the total depreciation adjustments for the intangible property, and (2) foreign source with respect to the remaining portion of the gain. IRC §865(c)(1).

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D. Subpart F Income; Tax Considerations Regarding Royalty Income of Offshore Corporations

§10.55 1. Generally

When a foreign corporation derives royalty income, the antideferral provisions set forth in subpart F of the Code (IRC §§951-965) may trigger an income inclusion for direct and indirect controlling U.S. shareholders if the foreign corporation is a controlled foreign corporation. The term "controlled foreign corporation" (CFC) means any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of IRC §958(a)), or is considered as owned by applying the rules of ownership of IRC §958(b), by U.S. shareholders on any day during the taxable year of such corporation. IRC §957(a). Under IRC §951(b), the term "U.S. Shareholder" means with respect to any foreign corporation, a U.S. person who owns (within the meaning of §958(a)), or who is considered as owning by applying the rules of ownership of §958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that foreign corporation.

NOTE: If the subpart F provisions do not apply because the foreign corporation is not a CFC, taxpayers must be aware of the passive foreign investment company (PFIC) rules (IRC §§1291-1298). A foreign corporation that is not a CFC is subject to the PFIC rules if either (1) 75 percent or more of its gross income is passive income as defined in IRC §954(c) (foreign personal holding company), or (2) 50 percent or more of the average value of its assets consists of assets that produce, or that are held for the production of, passive income. If the PFIC rules are applicable, special taxation rules apply. See IRC §1297(a).

When applicable, the subpart F provisions result in a deemed dividend inclusion for the U.S. shareholders of the CFC. The exposure to deemed dividend inclusions under subpart F is limited to the CFC's "subpart F income" (see below) for any particular year. Similarly, the deemed inclusion is limited to the CFC's current year earnings and profits (E&P). If a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a U.S. shareholder (see IRC §951(b)) of that corporation and who owns (within the meaning of §958(a)) stock in the CFC on the last day in that year on which the corporation is a CFC must include in gross income, for the U.S. shareholder's taxable year in which or with which the taxable year of the corporation ends, the U.S. shareholder's prorata share of the corporation's subpart F income for that year ((IRC §951(a)(1)(A)), and the amount determined under IRC §956 with respect to that U.S. shareholder for that year. IRC §951(a)(1)(B).

The term "subpart F income" includes any foreign personal holding company income (FPHCI) derived by the CFC in question. IRC §952. Internal Revenue Code §954(c)(1) generally defines FPHCI to include any income of the CFC that consists of dividends, interest, royalties, rents, or annuities. As a result, a CFC that earns royalty in any particular year could have subpart F income unless an exception applies. Section 954, however, has a number of important exceptions to FPHCI characterization. See §10.56.

In addition to including royalty income within the definition of FPHCI, the §954(c) FPHCI category also applies to any excess of gains over losses from the sale or exchange of certain classes of property that gives rise to dividends, interest, or royalties. IRC §954(c)(1)(B)(i). Under this provision, any gain realized from the sale of intellectual property that gives rise to royalty income could be subject to classification as subpart F income unless an exception is applicable.

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§10.56 2. Exceptions to FPHCI Classification

As discussed in §10.55, royalty income of a controlled foreign corporation (CFC) is typically classified as foreign personal holding company income (FPHCI) under IRC §954(c). Fortunately, there are numerous exceptions to this general rule.

For example, FPHCI does not include royalties that are derived by a CFC in the active conduct of a trade or business and received from an unrelated person. IRC §954(c)(2)(A). Royalty income is considered as being derived in the active conduct of a trade or business for purposes of §954(c)(2)(A) if the royalties are attributable to (Treas Reg §1.954-2(d)(1)):

- Property that the licensor developed, created, or produced;
- Property that the licensor acquired and added substantial value to, provided that the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind; or
- Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains a substantial (in relation to the amount of royalties derived from the intangible property) marketing organization in such country that is regularly engaged in the business of marketing.

NOTE: Whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. Treas Reg §1.954-2(d)(2)(ii). However, an organization will be considered substantial in relation to the amount of royalties if active licensing expenses equal or exceed 25 percent of the adjusted licensing profit. Treas Reg §1.954-2(d)(2)(ii).

Another important exception is the "same country" exception. Under the same country exception, FPHCI does not include royalties that are received by a CFC from a corporation that is a related person for the use of, or the privilege of using, property within the country under the laws of which the CFC is created or organized. IRC §954(c)(3)(A)(ii).

Finally, a look-through rule applies with respect to dividends, interest, rents, and royalties received by a CFC from a CFC that is a related person. IRC §954(c)(6). See also Notice 2007-9, 2007-5 Int Rev Bull 401 (Jan. 29, 2007). Qualifying payments received by a CFC will not be treated as subpart F income to the extent that the payments are attributable (or properly allocable under rules similar to the foreign tax credit rules) to income of the related party that is not subpart F income. IRC §954(c)(6). Royalties are generally allocable to the income to which they relate. Treas Reg §1.904-5(c)(3). As such, royalty income will generally be allocable to active income of the paying CFC, which in most cases will not be subpart F income.

NOTE: Section 954(c)(6) was introduced in May 2006 as part of the Tax Increase Prevention and Reconciliation Act of 2005, and was initially applicable for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to tax years of U.S. shareholders with or within which any such tax year of the foreign corporation ends. In October 2008, IRC §954(c)(6) was extended 1 year (for taxable years of foreign corporations beginning before January 1, 2010). See the Emergency Economic Stabilization Act of 2008 (Pub L 110-343, 122 Stat 3765). IRC §954(c)(6) has not been extended further. HR 2098, introduced in the House of Representatives on April 23, 2009, proposes to extend the application of the rule to taxable years of foreign corporations beginning before January 1, 2015.

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VI. REALLOCATION OF INCOME UNDER IRC §482

§10.57 A. Overview

Internal Revenue Code §482 authorizes the IRS to reallocate income between controlled taxpayers in order to prevent evasion of taxes or to clearly reflect the income of controlled organizations, trades, or businesses. Treasury Reg §1.482-1(a)(1) provides that the purpose of §482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to those transactions.

NOTE: The term "controlled taxpayer" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests; it includes the taxpayer that owns or controls the other taxpayers. "Uncontrolled taxpayer" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests. Treas Reg §1.482-1(i)(5). "Controlled" includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. Treas Reg §1.482-1(i)(4).

The regulations state that the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. Treas Reg §1.482-1(b)(1). A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. Because identical transactions can rarely be found, however, whether a transaction produces an arm's-length result will generally be determined by reference to the results of comparable transactions under comparable circumstances. Treas Reg §1.482-1(b)(1).

The regulations at Treas Reg §1.482-1(d)(3)(ii)(B)(1) provide that the IRS will respect the terms of a written contract that is agreed to before a transaction is entered into if the contract is consistent with the economic substance of the underlying transaction. If, however, the contractual terms are not consistent with the transaction's economic substance, the IRS may disregard the contractual terms and impute terms that are consistent with the economic substance of the transaction. Treas Reg §1.482-1(d)(3)(ii)(B)(1). If there is no written agreement, the IRS may impute an agreement between the controlled taxpayers consistent with the economic substance of the transaction. Treas Reg §1.482-1(d)(3)(ii)(B)(2).

The regulations provide guidance and limitations regarding the IRS's authority to use the contract imputation rules. The regulations have several examples that suggest that the IRS has almost unlimited discretion to impute both economic substance and contractual terms. See, *e.g.,* Treas Reg §1.482-1(d)(3)(ii)(C), Example 3.

EXAMPLE: In Example 3 of Treas Reg §1.482-1(d)(3)(ii)(C), a U.S. subsidiary acted as a distributor for its foreign parent's trademarked products. In years 1 through 6, the U.S. subsidiary engaged in incremental marketing activities beyond those engaged in by comparable companies. The year being examined is year 7. The example concludes that the IRS has authority to impute additional contractual terms because the U.S. subsidiary performed incremental marketing activities for which it was not compensated. The example lists a host of contractual terms that the IRS may impute to the agreement. The example concludes that the taxpayer's failure to properly compensate the U.S. subsidiary results in a deemed transfer of an intangible from the foreign parent to the U.S. subsidiary.

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B. Transfers and Licenses of Intangible Property

§10.58 1. Commensurate-With-Income Standard

One important application of IRC §482 is to transfers of intangibles: "In the case of any transfer (or license) of intangible property (within the meaning of [IRC] §936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible" (referred to in this discussion as the "commensurate-with-income" standard). IRC §482. An "intangible" is an asset that comprises any of the following items and has substantial value independent of the services of any individual: (1) patents, inventions, formulae, processes, designs, patterns, or know-how; (2) copyrights and literary, musical, or artistic compositions; (3) trademarks, trade names, or brand names; (4) franchises, licenses, or contracts; (5) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and (6) other similar items. Treas Reg §1.482-4(b). The Obama administration's fiscal 2010 budget proposal (JCS-3-09) proposes to "clarify" the definition of intangible property to include workforce-in-place, goodwill, and going concern value. This would be a significant change to the definition of intangibles under §482.

NOTE: Before the Tax Reform Act of 1986 ("1986 Tax Act"), §482 only authorized the IRS to allocate income deductions and other tax items among controlled taxpayers to prevent evasion of taxes or clearly to reflect their income. The 1986 Tax Act amended §482 to provide the commensurate-with-income standard. The reason for the legislation was the view that contractual arrangements between unrelated parties, particularly those involving high profit intangibles, are not entered into on a long-term basis without some mechanism for adjusting the arrangement if the profitability of the intangible is significantly higher or lower than anticipated. Congress concluded that it is consistent with the arm's-length standard to treat related-party license agreements as renegotiable arrangements and to require periodic adjustments to the transfer price to reflect substantial changes in the income stream attributable to the intangible. HR Conf Rep No. 841, 99th Cong, 2d Sess II-637-638 (1986).

In enacting the commensurate-with-income standard, the House Ways and Means Committee Report criticized the ability of taxpayers to transfer "high-profit potential intangibles" at an early stage "for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product." HR Rep p 424. In making the change, the committee stated its intent to make clear that neither industry norms nor unrelated-party transactions provide a safe-harbor minimum payment for related-party transfers of intangibles. When taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. HR Rep p 425. The committee, however, did not intend that the inquiry regarding the appropriate compensation for the intangible should be limited to the question of whether the compensation was appropriate considering only the facts in existence at the time of the transfer. The committee intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. HR Rep p 425.

In Notice 88-123 (White Paper), the IRS issued a report that discusses the commensurate-with-income standard. It states that the primary difficulty addressed by the 1986 Tax Act was the selective transfer of high profit intangibles to tax havens. Because these intangibles are so often unique and typically not licensed to unrelated parties, it is difficult, if not impossible, to find comparables from which an arm's-length transfer price can be determined. The White Paper echoes the concerns expressed in the House Report that taxpayers often did not consider the potential profitability of the transferred intangible as demonstrated by post-agreement results. Notice 88-123, 1988-2 Cum Bull 458. The White Paper further states that looking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. Thus, the general goal of the commensurate-with-income standard is to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's-length transfer of the intangible. Under the commensurate-with-income standard, the actual profit experience should be used to determine the appropriate compensation for the intangible, and periodic adjustments (see §10.63) should be made to reflect changes in intangible income as well as changes in the economic activities performed and economic costs and risks borne by the related parties in exploiting the intangibles. Notice 88-123, 1988-2 Cum Bull 458.

NOTE: There is no case law on the commensurate-with-income standard.

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§10.59 2. Methods for Determining Arm's-Length Amount

Under Treas Reg §1.482-4(a), the arm's-length amount charged in a controlled transfer of intangible property is required to be determined using one of four methods. The arm's-length consideration for the transfer of an intangible determined under IRC §482 must also be commensurate with the income attributable to the intangible. Treasury Regulation §1.482-1(c) provides the "best method rule." Under the best method rule, the arm's-length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Treas Reg §1.482-1(c).

The Obama administration's fiscal 2010 budget proposal (JCS-3-09) would also provide that (1) in a transfer of multiple intangible properties the Internal Revenue Service may value the intangible properties on an aggregate basis when doing so achieves a more reliable result and (2) intangible property must be valued at its highest and best use, "as it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment, JCS-4-09 (Sept 2009) at 36-37.

Following are the four methods provided in Treas Reg §1.482-4(a):

The comparable uncontrolled transaction (CUT) method. The CUT method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. Whether the results derived from applying this method are the most reliable measure of an arm's-length result is determined using the factors described under the so-called "best method" rule (the two primary factors being the degree of comparability between the controlled transaction and any uncontrolled comparables and the quality of the data and assumptions used in the analysis). Treas Reg §§1.482-4(c), 1.482-1(c)(1), (2).

The comparable profits method (CPM). The CPM generally requires an analysis of the least complex of the controlled parties and a test of that party's financial results against the financial results from unrelated parties engaging in similar business activities under similar circumstances. In general, the CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (referred to in this discussion as "profit level indicators") derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Under the CPM, the determination of an arm's-length result is based on the amount of operating profit that the tested party would have earned on related-party transactions if its profit level indicator were equal to that of an uncontrolled comparable. Treas Reg §1.482-5.

The profit split method. The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. Treas Reg §1.482-6. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (referred to in this discussion as the "relevant business activity"). The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, the risks assumed, and the resources employed by each participant in the relevant business activity, consistent with the comparability provisions of Treas Reg §1.482-1(d)(3). The end result of this comparison attempts to achieve the same allocation of profit that would have occurred between unrelated parties engaged in the same business segment as the controlled parties with each performing similar functions. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The allocation of profit or loss under this method must be made in accordance with either the so-called "comparable profit split" method or the "residual profit split" method described in the regulations. See Treas Reg §1.482-6(c).

Unspecified methods. Other methods may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used must be applied in accordance with the provisions of Treas Reg §1.482-1. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction and only enter into a particular transaction if none of the alternatives is preferable to them. Treas Reg §1.482-4(d).

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§10.60 3. Ownership of Intangible Property

The question of whether a party is an owner of intangible property at issue is important for determining whether an allocation can be made. Rules relating to ownership of intangibles were recently finalized.

Treas Reg §1.482-4 (TD 9456), applicable for tax years beginning after July 31, 2009, finalized the determination of intellectual property ownership for purposes of IRC §482. In a departure from past precedent, the regulations provide a three-pronged analysis that, when coupled with the IRS's ability to impute contractual terms (see §10.57), gives the IRS broad authority to disregard a taxpayer's intellectual property ownership structure.

The regulations provide that, as a general rule, the legal owner of an intangible under the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the intangible for purposes of §482. Treas Reg §1.482-4(f)(3). However, the legal owner of an intangible property right will not be considered the sole owner for §482 purposes if the IRS determines that the ownership is inconsistent with the economic substance of the underlying transactions. If no legal owner is identified under the relevant intellectual property laws or contractual terms, then the controlled taxpayer who controls the intangible, based on all the facts and circumstances, will be considered the sole owner of the intangible for purposes of §482. Treas Reg §1.482-4(f)(3).

NOTE: The rules in the 2009 final regulations were based on Temp Treas Reg §1.482-4T (TD 9278), applicable for tax years beginning after December 31, 2006. The 2009 Treas Reg §1.482-4 finalized the temporary regulations without change.

Example 2 of Treas Reg §1.482-4(f)(3)(ii) illustrates these important new rules. In Example 2, a U.S. subsidiary of a foreign parent company holds the exclusive right to manufacture and market products in the U.S. under its foreign parent's trademark. In the process of exploiting the licensed intangible, the U.S. subsidiary develops a customer list (also an intangible). The contract between the foreign parent and the U.S. subsidiary does not specify which entity is the legal owner of the customer list developed by the U.S. subsidiary. The example concludes that because the U.S. subsidiary has knowledge of the list's contents and practical control over its use and dissemination, the U.S. subsidiary is considered the owner of the customer list for purposes of §482.

NOTE: Example 2 emphasizes that, in drafting intercompany agreements, related taxpayers should be careful to identify intellectual property ownership clearly as between the parties and thereby avoid any unintended ownership consequences. Use of the control rule to automatically deem the U.S. subsidiary to own the customer list, solely because ownership is not addressed in the controlling contract, is questionable, however. Unfortunately, thoroughness in drafting intercompany agreements will not provide an absolute defense to a reallocation of intellectual property rights under the new regulations, because the IRS can ignore the legal owner if it determines that the ownership is inconsistent with the economic substance of the underlying transactions.

The regulations also provide that the arm's-length consideration for a contribution by one controlled taxpayer that develops or enhances the value (or may be reasonably anticipated to develop or enhance the value) of an intangible owned by another controlled taxpayer will be determined in accordance with the applicable rules under §482. Treas Reg §1.482-4(f)(4). If the consideration for the contribution is included in the contractual terms for a controlled transaction that involves such an intangible, ordinarily no separate allocation will be made for the contribution. In these cases, the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's-length consideration in the controlled transaction. Treas Reg §1.482-4(f)(4).

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§10.61 a. Treas Reg §1.482-4(f)(3) (for Tax Years Beginning Before January 1, 2007) [Deleted]

This section has been deleted because the text is obsolete.

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§10.62 b. Temp Treas Reg §1.482-4T(f)(3) (for Tax Years Beginning After December 31, 2006) [Deleted]

This section has been deleted because its text has been moved to §10.60.

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§10.63 4. Periodic Adjustments

One application of the commensurate-with-income standard (see §10.58) is to controlled-party licenses that require payment of periodic royalties. For example, assume a U.S. parent grants a license to its foreign subsidiary to manufacture and sell products using a patented manufacturing process and the parent's valuable trademark. The profits might be arm's length based on data contemporaneous with the transfer, but later exceed projections. As a result, an increased royalty in the later years could be imposed based on actual profits.

As a general rule, if an intangible is transferred under an arrangement that lasts more than 1 year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Treas Reg §1.482-4(f)(2)(i). The determination in an earlier year that the amount charged for an intangible was an arm's-length amount will not preclude the IRS in a subsequent taxable year from making an adjustment to the amount charged for the intangible in a subsequent year. In determining whether to make adjustments in the taxable year under examination, the IRS may consider all relevant facts and circumstances throughout the period that the intangible is used. A periodic adjustment may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. Treas Reg §1.482-4(f)(2)(i).

One important exception is for transactions involving the same intangible. Treas Reg §1.482-4(f)(2)(ii)(A). No allocation in a subsequent year will be made for a controlled transfer of intangible property if the same intangible was transferred to an uncontrolled taxpayer (an uncontrolled transaction) under substantially the same circumstances as those of the controlled transaction. The uncontrolled transaction serves as the basis for application of the CUT method (see §10.59) in the taxable year in which substantial periodic consideration was required to be paid, and the amount paid in that year is deemed to be an arm's-length amount. Treas Reg §1.482-4(f)(2)(ii)(A).

Another important exception is for transactions in which the arm's-length result is derived from application of the CUT method based on transfer of a comparable intangible under comparable circumstances. Under this exception, no allocation will be made if several requirements are satisfied, including one that a comparable uncontrolled transaction was relied on to establish the arm's-length consideration. Treas Reg §1.482-4(f)(2)(ii)(B).

Further, if the arm's-length amount was determined under any method other than the CUT method, no allocation will be made if a number of requirements are satisfied, including a requirement that the total profits actually earned (or total cost savings realized) by the transferee from exploitation of the intangible in the year under examination and all past years are not less than 80 percent nor more than 120 percent of the prospective profits or cost savings that were foreseeable when the agreement was entered into. Treas Reg §1.482-4(f)(2)(ii)(C).

Finally, the regulations provide an exception for certain extraordinary events. Under this exception, no allocation will be made if several requirements are met, including a requirement that the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80 percent or more than 120 percent of the prospective profits or cost savings as a result of extraordinary events that were beyond the control of the taxpayers and that could not reasonably have been anticipated when the controlled agreement was entered into. Treas Reg §1.482-4(f)(2)(ii)(D).

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§10.64 C. Cost Sharing Arrangements

Under a Cost sharing arrangement (CSA), two or more controlled parties agree to contribute jointly to the cost of developing an intangible asset in return for a specified ownership interest in any intangible asset that is developed. The IRS should not later reallocate a royalty payment from one entity to another under IRC §482 in this circumstance because each controlled party should own an interest in the intangible asset that they jointly develop. See §§10.65-10.73.

The former regulations under Treas Reg §1.482-7 apply to taxable years beginning before January 5, 2009 (the Prior Cost Sharing Regulations). In 2005, proposed cost sharing regulations (the Proposed Regulations) were issued which significantly modified the Prior Cost Sharing Regulations. See the Preamble to Prop Treas Reg §1.482-7; REG-144615-02 (Aug 29, 2006). On December 31, 2008, temporary and proposed regulations that cover cost sharing arrangements were issued (the Temporary Cost Sharing Regulations). See IRB 2009-7 (TD 9441) (February 17, 2009). These regulations apply on January 5, 2009; however, important grandfather rules apply for existing CSAs. Existing CSAs under the Prior Cost Sharing Regulations must have been modified by July 6, 2009, to comply with the requirements of the temporary regulations. A CSA statement also must have been filed by September 2, 2009.

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1. Prior Cost Sharing Regulations

§10.65 a. In General

Under the Prior Cost Sharing Regulations, a Cost sharing arrangement (CSA) is defined as an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to the parties' shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the agreement. Treas Reg §§1.482-7(a)(1), 1.482-7(b). The phrase "reasonably anticipated benefits" means the additional income generated or costs saved by use of the intangibles subject to the agreement. Treas Reg §1.482-7(e)(1). A controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates it will derive from the intangibles. Treas Reg §1.482-7(e)(2).

NOTE: The Temporary Cost Sharing Regulations (see §10.68-10.74) redesignate Treas Reg §1.482-7 as Treas Reg §1.482-7A.

The IRS may not make allocations with respect to a qualified CSA except to the extent necessary to make each controlled participant's share of the costs of intangible development equal to its share of reasonably anticipated benefits. Treas Reg §1.482-7(a)(2). If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), the IRS may make appropriate allocations to reflect an arm's-length consideration for acquisition of the interest in such intangible. Treas Reg §1.482-7(a)(2).

Under Treas Reg §1.482-7(b), taxpayers must meet several detailed procedural requirements, including reporting and accounting requirements, in order to have a qualified CSA.

For purposes of determining whether a cost allocation is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified CSA must be compared to its share of reasonably anticipated benefits under the arrangement. Treas Reg §1.482-7(f)(1). A controlled participant's share of "intangible development costs" for a taxable year is equal to its intangible development costs for the taxable year, divided by the sum of the intangible development costs for the taxable year of all the controlled participants. Treas Reg §1.482-7(f)(2). A controlled participant's share of "reasonably anticipated benefits" under a qualified CSA is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits of all the controlled participants. Treas Reg §1.482-7(f)(3).

NOTE: The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. Treas Reg §1.482-7(f)(3). In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits: (1) the reliability of the basis used for measuring benefits, and (2) the reliability of the projections used to estimate benefits. Treas Reg §1.482-7(f)(3).

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§10.66 b. Buy-In Payments

As noted in §10.64, in a Cost sharing arrangement (CSA), controlled participants (CPs) generally agree to contribute jointly to the costs of developing an intangible asset in return for a specified interest in the developed asset. When a CP contributes preexisting intangible property (or intangible property that it acquired) to the CSA, the regulations treat such contributions as a transfer of interest in the contributed intangible asset to the other CP. Treas Reg §1.482-7(g)(2). As a result, a buy-in payment must be made to each contributing CP. The buy-in payment constitutes regular income to the recipient (*e.g.,* royalty income). Treas Reg §1.482-7(h)(1). The IRS may make appropriate allocations to a buy-in payment under the §482 rules discussed in §§10.57-10.63. Treas Reg §1.482-7(g)(1).

If a group of controlled taxpayers participates in a qualified CSA, any change in the CPs' interests in covered intangibles—whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants—constitutes a transfer of intangible property. Treas Reg §1.482-7(g)(1). If a new CP enters into a qualified CSA and acquires any interest in the covered intangibles, the new CP must pay an arm's-length consideration for that interest to each CP from whom an interest was acquired. Treas Reg §1.482-7(g)(3). Likewise, a CP in a qualified CSA may be deemed to have acquired an interest in one or more covered intangibles if another CP transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first CP. If a relinquishment occurs, the CP relinquishing an interest must receive an arm's-length consideration in return. If the CP that relinquished its interest subsequently uses that interest, that CP must pay an arm's-length consideration to the CP that acquired the interest. Treas Reg §1.482-7(g)(4).

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§10.67 c. Stock-Based Compensation

Before the issuance of the final regulations effective for stock-based compensation granted in taxable years beginning after August 25, 2003 (TD 9088), Treas Reg §1.482-7 did not provide rules addressing whether stock-based compensation was to be included in a controlled participant's (CP's) costs of developing intangible property pursuant to a Cost sharing arrangement (CSA). The issue was addressed in *Xilinx Inc. v Comm'r* (2005) 125 TC 37. *Xilinx* involved a U.S. parent company (Xilinx) that entered into a CSA with a foreign subsidiary. Xilinx issued stock options to its employees, including those performing research and development. In determining the allocation of costs under the CSA, Xilinx did not include in research and development (R&D) costs any amounts related to the issuance of stock options to (or exercise of stock options by) its employees. 125 TC at 39. The IRS sought to require that Xilinx's stock option compensation be included as an R&D cost for Cost sharing purposes.

The Tax Court in *Xilinx* noted that the broad grant of authority to the IRS under IRC §482 to allocate income and deductions between controlled parties is limited by Treas Reg §1.482-1, which sets forth the "general principles and guidelines to be followed under §482." Treasury Regulation §1.482-1(b)(1) states that in determining true taxable income, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." The Tax Court stated that nothing in §482, its accompanying regulations, or its legislative history indicates that internal measures of cost and profit should be used to the exclusion of the arm's-length standard. 125 TC at 57. Xilinx's uncontradicted evidence established that, in determining cost allocations, unrelated parties would not include any cost related to the issuance of employee stock options. 125 TC at 59. The Tax Court therefore held that the IRS's allocation was contrary to the arm's-length standard mandated by Treas Reg §1.482-1(b) because uncontrolled taxpayers would not allocate the spread or grant date value relating to employee stock options to R&D costs subject to Cost sharing computations. The Tax Court also held that Xilinx's allocation, without stock option compensation, satisfied the arm's-length standard.

In *Xilinx, Inc. v Comm'r* (9th Cir 2009) 567 F3d 482, however, the Ninth Circuit reversed the Tax Court. The Ninth Circuit agreed in part with the Tax Court, stating that "the record conclusively establishes that the companies in a joint venture operating at arm's length do not share [employee stock option] costs." The Ninth Circuit further held that although the §482 Cost sharing regulation in this case requires non–arm's length dealings, it nonetheless should be enforced. The court stated that the arm's length standard is merely a "regulatory gloss" on the Service's statutory authority under §482. Xilinx has asked the Ninth Circuit to review its decision that affiliates in a cost- sharing joint venture to develop intangibles must share all costs of that venture, including stock options, under the §482 regulations.

NOTE: Readers are cautioned that on January 13, 2010, as this update was in production, the Ninth Circuit withdrew its prior opinion. See *Xilinx, Inc. v Comm'r* (9th Cir, Jan 13, 2010, Nos. 06-74246, 06-74269) 2010 US App Lexis 778.

Regulations were finalized effective August 26, 2003, in the middle of the *Xilinx* litigation. Treasury Regulation §1.482-7(d)(2)(i) now provides that a CP's operating expenses includes all costs attributable to compensation, including stock-based compensation. "Stock-based compensation" means any compensation provided by a CP to an employee or independent contractor in the form of equity instruments, stock options, or rights with respect to equity instruments or stock options, including but not limited to property to which §83 applies and stock options to which §421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property. Treas Reg §1.482-7(d)(2)(i).

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2. Temporary Cost Sharing Regulations

§10.68 a. Proposed Regulations

The proposed cost sharing regulations, issued in 2005, significantly revised the current regulations discussed in §§10.65-10.67. The proposed regulations were based on the "investor model." Under this model, each participant is viewed as making an "aggregate investment" consisting of both ongoing research and development (R&D) cost contributions and any "external" contributions (*i.e.,* preexisting intellectual property). The anticipated return to each participant is intended to be appropriate to the risks of the CSA over the entire term of its development and exploitation of intellectual property. See the Preamble to Prop Treas Reg §1.482-7; REG-144615-02 (Aug. 29, 2006). The purpose of the proposed regulations was to provide guidance for cost sharing arrangements (CSAs) concerning the returns that would have been achieved by uncontrolled taxpayers entering into the same transaction in the same circumstances. Preamble to Prop Treas Reg §1.482-7; REG-144615-02 (Aug. 29, 2006); Treas Reg §1.482-1(b)(1).

Under the investor model, each controlled participant will be viewed as making an aggregate investment, attributable both to cost contributions (*i.e.,* its ongoing share of intangible development costs) and to external contributions (*i.e.,* the buy-in), for purposes of achieving an anticipated return appropriate to the risks of the CSA over the term of the development and exploitation of the intangibles resulting from the arrangement. See Preamble to Prop Treas Reg §1.482-7; REG-144615-02 (Aug. 29, 2006). The investor model assumes that parties at arm's length would not invest, along with their ongoing cost contributions, in the absence of an appropriate reward. Thus, under the investor model, valuations are not appropriate if an investor would not undertake to invest in the arrangement because its total anticipated return is less than the total anticipated return that could have been achieved through an alternative investment that is realistically available to it. See Preamble to Prop Treas Reg §1.482-7; REG-144615-02 (Aug. 29, 2006).

NOTE: One important implication of the investor model is that arm's-length compensation for external contributions must be analyzed and valued as of a date preceding the transaction. See Prop Treas Reg §1.482-7(b)(3)(iii).

The proposed regulations had as their underpinning the theory that the investor (presumably the U.S. parent company) must earn a total anticipated return that is more than, or at least equal to, the total anticipated return that it could have achieved through another alternative investment that was realistically available to it. The parent company presumably must compare alternatives at the time when it incurs R&D costs and licenses intangibles to its foreign subsidiaries under a CSA. The foreign subsidiary entering into a CSA presumably also must earn a total anticipated return that is more than, or at least equal to, the total anticipated return that it could have achieved through an alternative investment that is realistically available to it. Thus, a foreign subsidiary that enters into a CSA apparently must also improve its own return, presumably by comparing (1) the payment of a royalty to the U.S. parent company with (2) the cost-shared R&D amount plus the buy-in.

NOTE: The approach of considering alternatives available to the taxpayer was rejected in *Bausch & Lomb v Comm'r* (1989) 92 TC 525, aff'd (2d Cir 1991) 923 F2d 1084. In that case, the IRS argued unsuccessfully that the U.S. parent company could have manufactured the contact lenses at issue at a cost less than what it paid its Irish subsidiary for the lenses, and should not have paid the subsidiary more than its own hypothetical cost to manufacture. Despite specific criticism by the Tax Court, the IRS and Treasury nonetheless included the "alternatives available" theory in the proposed Cost sharing regulations discussed above. See Treas Reg §1.482-1(f)(2)(ii).

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§10.69 b. Temporary Cost Sharing Regulations

The temporary cost sharing regulations (Temporary Cost Sharing Regulations) are also based on the "investor model." Under the Temporary Cost Sharing Regulations, controlled participants share intangible development costs (IDCs) in proportion to their shares of reasonably anticipated benefits (RAB shares) by entering into cost sharing transactions (CSTs). Temp Treas Reg §1.*4*28-*7*T(a)(1), (b)(1). The arm's length amount charged in a platform contribution transaction (PCT), a "buy-in", must be determined under the method or methods applicable under the other section or sections of the IRC §*4*82 regulations, as supplemented by the rules under Temp Treas Reg §1.*4*82-*7*T(g). Temp Treas Reg §1.*4*82-*7*T(a)(2). Under the Temporary Cost Sharing Regulations, a controlled participant means a controlled taxpayer (one of two or more taxpayers owned or controlled directly or indirectly by the same interests) that is a party to the contractual agreement that underlies the cost sharing arrangement (CSA), and that reasonably anticipates that it will derive benefits, from exploiting one or more cost-shared intangibles. Temp Treas Reg §1.*4*82-*7*T(j)(1)(i).

Under the Temporary Cost Sharing Regulations, an arrangement qualifies as a CSA only if (1) the controlled participants meet both substantive and administrative requirements; (2) the controlled participants enter into a PCT, *i.e.,* a buy-in, as of the earliest date on or after the CSA is entered into on which a platform contribution (see §10.71) is reasonably anticipated to contribute to developing cost-shared intangibles, and (3) each controlled participant receives a non-overlapping interest in the cost-shared intangibles without further obligation to compensate another controlled participant for such interest. Temp Treas Reg §1.*4*82-*7*T(b).

The substantive requirements mandate that all controlled participants commit to, and in fact engage in, CSTs, *i.e.,* the controlled participants make payments to each other (CST payments) as appropriate, so that in each taxable year each controlled participant's IDC share is in proportion to its respective RAB share. The substantive requirements also mandate that all controlled participants commit to, and in fact engage in, PCTs to the extent that there are platform contributions. Except for grandfathered CSAs (see §10.70), the substantive requirements further mandate that each controlled participant receive a non-overlapping interest in the cost-shared intangibles without further obligation to compensate another controlled participant for such interest. Temp Treas Reg §1.*4*81-*7*T(b)(1).

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§10.70 c. Divisional Interests

The Temporary Cost Sharing Regulations require that the controlled participants in the cost sharing arrangement (CSA) have non-overlapping interests in the cost-shared intangibles. Temp Treas Reg §1.482-7T(b)(1)(iii). The CSA must entitle each controlled participant to the perpetual and exclusive right to the profits attributable to such interest in the cost-shared intangibles. Temp Treas Reg 1.482-7T(b)(4)(i). This requirement does not apply to grandfathered CSAs (those that were in existence before January 5, 2009, and were amended to otherwise comply with the Temporary Cost Sharing Regulations by July 6, 2009). Temp Treas Reg. §1.482-7T(m)(2)(iii).

Under territorial-based divisional interests, the entire world must be divided into two or more non-overlapping geographic territories. Each controlled participant must receive at least one such territory, and in the aggregate all the participants must receive all such territories. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost-shared intangibles through the use, consumption, or disposition of property or services in its territories. Temp Treas Reg §1.482-7T(b)(4)(ii).

The CSA can instead use a "field of use" to dividend the interests in the cost-shared intangibles, *i.e.*, the CSA may divide all interests in cost-shared intangibles on the basis of all uses (whether or not known at the time of the division) to which cost-shared intangibles are to be put. All anticipated uses of cost-shared intangibles must be identified. Each controlled participant must be assigned at least one anticipated use, and in the aggregate all the participants must be assigned all such anticipated uses. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost-shared intangibles through the use or uses assigned to it, and one controlled participant must be assigned the exclusive and perpetual right to exploit cost- shared intangibles through any unanticipated uses. Temp Treas Reg §1.482-7T(b)(4)(iii).

The Temporary Cost Sharing Regulations also authorize other non-overlapping divisional interests, provided that the basis used meets certain criteria: (1) the basis must clearly and unambiguously divide all interests in cost-shared intangibles among the controlled participants; (2) the consistent use of this basis can be dependably verified from the participant's records; (3) the rights of the controlled participants to exploit cost-shared intangibles are non-overlapping, exclusive, and perpetual; and (4) the resulting benefits associated with each controlled participant's interest in cost-shared intangibles are predictable with reasonable reliability. Temp Treas Reg §1.482-7T(b)(4)(iv).

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§10.71 d. Platform Contribution Transactions (Buy-In Transactions)

As noted in §10.69, platform contribution transactions (PCTs) (referred to in the prior Cost sharing regulations as buy-ins) must be made for all platform contributions. A platform contribution is defined as any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the cost sharing arrangement (CSA)) that is reasonably anticipated to contribute to developing cost-shared intangibles. A resource, capability, or right reasonably determined not to be a platform intangible as of an earlier point in time may be reasonably determined to be a platform intangible at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that the resource or capability or right has not contributed, and is not longer reasonably anticipated to contribute, to developing cost-shared intangibles. Temp Treas Reg §1.482-7T(c).

For purposes of a PCT, the PCT payee's provision of a platform contribution is presumed to be exclusive. It also is presumed that the platform resource, capability, or right is not reasonably anticipated to be committed to any business activities other than the CSA activity. Temp Treas Reg 1.482-7T(c)(2)(i). The controlled participants may rebut the presumption. For example, if the platform resource is a research tool, then the controlled participants could rebut the presumption by establishing to the satisfaction of the Service that as of the date of the PCT, the tool is reasonably anticipated not only to contribute to CSA activity but also to be licensed to an uncontrolled taxpayer. Temp Treas Reg 1.482-7T(c)(2)(ii).

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§10.72 e. Transfers of an Interest in a Cost-Shared Intangible and Changes in Participation

If at any time (during the term, or on or after the termination, of a cost sharing arrangement (CSA)) a controlled participant transfers an interest in a cost-shared intangible to another controlled taxpayer, the controlled participant must receive an arm's length amount of consideration from the transferee under the rules of Treas Reg §§1.482-1 and 1.482-4 through 1.482-6 as supplemented by Temp Treas Reg §1.482-7T(f)(4) regarding arm's length consideration for a change in participation. Temp Treas Reg §1.482-7T(f)(4).

In the event of a change in participation, the arm's length amount of consideration must be determined consistent with the reasonably anticipated incremental change in returns to the transferee or transferor resulting from the change in participation. Temp Treas Reg §1.482-7T(f)(4). A change in participation under a CSA occurs when there is either a controlled transfer of interests or a capability variation. Temp Treas Reg §1.482-7T(f)(1).

A controlled transfer occurs when a participant in a CSA transfers all or part of its interest in cost-shared intangibles under the CSA in a controlled transaction, and the transferee assumes the associated obligations under the CSA. In such a case, the transferee will be treated as succeeding to the transferor's prior history under the CSA as it pertains to the transferred interest, including the transferor's cost contributions, benefits received, and PCT payments attributable to such rights or obligations. Temp Treas Reg §1.482-7(f)(2).

A capability variation occurs when, in a CSA in which interests in cost-shared intangibles were divided on a basis such as plant capacity, the controlled participants' division of interests or their relative capabilities or capabilities to benefit from the cost-shared intangibles are materially altered. Temp Treas Reg §1.482-7T(f)(3).

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§10.73 f. Forms of Payment

Cost sharing transaction (CST) payments may not be made in shares of stock of the payor (or stock in any member of the controlled group that includes the controlled participants). Temp Treas Reg §1.482-7T(h)(1).

The consideration under a platform contribution transaction (PCT) for a platform contribution may take one or a combination of both of the following forms: (1) payments of a fixed amount (fixed payments), either paid in a lump sum or in installment payments spread over a specified period, with interest calculated in accordance with Treas Reg §1.482-2(a) (loans or advances); and (2) payments contingent on the exploitation of cost-shared intangibles by the PCT payor (contingent payments). Temp Treas Reg §1.482-7T(h)(2)(i). PCT payments may not be paid in shares of stock in the PCT payor (or stock in any member of the controlled group that includes the controlled participants). Temp Treas Reg §1.482-7T(h)(2)(ii).

The form of payment for any PCT must be specified no later than the due date of the applicable tax return (including extensions) for the later of the taxable year of the PCT payor or PCT payee that includes the date of that PCT. Temp Treas Reg §1.482-7T(h)(2)(iii)(A).

A provision of a written contract or of the additional documentation that provides for payments for a PCT (or group of PCTs) to be contingent on the exploitation of cost-shared intangibles will be respected as consistent with economic substance only if the allocation between the controlled participants of the risks attendant on the form of payment is determinable before the outcomes of that allocation that would have materially affected the PCT pricing are known or reasonably knowable. A contingent payment provision must clearly and unambiguously specify the basis on which the contingent payment obligations are to be determined. The contingent payment provision must clearly and unambiguously specify the events that give rise to an obligation to make PCT payments, the royalty base (such as sales or revenues), and the computation used to determine the PCT payments. Temp Treas Reg §1.482-7T(h)(2)(iii)(B).

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§10.74 g. Periodic Adjustments

The Commissioner may make periodic adjustments for an open taxable year (the Adjustment Year) and for all subsequent taxable years for the duration of the cost sharing arrangement (CSA) activity with respect to all platform contribution transaction (PCT) payments. To avoid periodic adjustments, taxpayer's actually experienced return ratio (AERR) must be within a periodic return ratio range (PRRR) of.667 and 1.5 (or between 0.8 and 1.25 if the taxpayer has not substantially complied with the documentation requirements). AERR is the present value of the operating profits from exploiting the cost-shared intangibles divided by the participant's investment in the CSA (both intangible development costs and PCTs). Temp Treas Reg §1.482-7T(i)(6).

There are many exceptions to periodic adjustments. No periodic adjustment will be made if the same platform contribution was furnished to an uncontrolled taxpayer under substantially the same circumstances as those of the particular PCT that the Commissioner is adjusting (the Trigger PCT) and with a similar form of payment as the Trigger PCT. This only applies if the transaction served as the basis for the application of the comparable uncontrolled transaction (CUT) method in the first year and all subsequent years in which substantial PCT payments relating to the Trigger PCT were required to be paid. The amount of the PCT payments in the first year must have been at arm's length. Temp Treas Reg §1.482-7T(i)(6)(vi)(A)(1).

No periodic adjustment will be made if the differential is due to extraordinary events beyond the control of the controlled participants that could not reasonably have been anticipated as of the date of the Trigger PCT. Temp Treas Reg §1.482-7T(i)(6)(vi)(A)(2).

Another exception is if the periodic adjustment would not have occurred had the PCT payor's divisional profits or losses used to calculate its present value of the operating profits (for purposes of calculating AERR) excluded those profits or losses attributable to the PCT payor's routine contributions to its exploitation of the cost-shared intangibles, attributable to its operating cost contributions, and attributable to its non-routine contributions to the CSA activity. Temp Treas Reg §1.482-7T(i)(6)(vi)(A)(3).

An exception applies if the periodic trigger would not have occurred had the divisional profits or losses of the PCT payor used to calculate its present value of operating profits included its reasonably anticipated divisional profits or losses after the adjustment year from the CSA activity, including its routine contributions, its operating cost contributions, and its non-routine contributions to that activity, and had the cost contributions and PCT payments of the PCT payor used to calculate the participant's investment in the CSA included its reasonably anticipated cost contributions and PCT payments after the adjustment year. Temp Treas Reg §1.482-7T(i)(6)(vi)(A)(4).

A periodic trigger will also not be deemed to have occurred in any year subsequent to the 10-year period beginning with the first taxable year in which there is substantial exploitation of the cost-shared intangibles resulting from the CSA, if the AERR is within the PRRR for each year of the 10-year period. It also will not be deemed to have occurred in any year of the 5-year period beginning with the first taxable year in which there is exploitation of the cost-shared intangibles resulting from the CSA if the AERR falls below the lower boundary of the PRRR. Temp Treas Reg §1.482-7T(i)(6)(vi)(B).

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§10.75 h. Transition Rule

An arrangement in existence on January 5, 2009, will be considered a cost sharing arrangement (CSA) if, before that date, it was a qualified CSA, and if the written contract was amended to conform with, and the activities of the controlled participants substantially complied with, the provisions of the Temporary Cost Sharing Regulations by July 6, 2009. Cost sharing transactions (CSTs) and platform contribution transactions (PCTs) occurring before January 5, 2009 are subject to the prior Cost sharing regulations. Temp Treas Reg 1.482-7(t)(m).

PCTs that occur under a CSA that was a qualified CSA and remained in effect on January 5, 2009 are subject to the periodic adjustment rules of the prior cost sharing regulations. The periodic adjustment rules in the Temporary Cost Sharing Regulations apply to PCTs that occur on or after the date of a material change in the scope of the CSA from its scope as of January 5, 2009. Temp Treas Reg 1.482-7(t)(m)(3).

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11

Selected International Issues

Stafford Matthews

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§11.1 I. INTRODUCTION

An agreement is in effect the creation of a private legal system between the parties concerning their particular transaction. In their negotiations, the parties legislate all the rights and obligations that they intend to have as it pertains to their matter. This private legal system will fail dramatically, however, if additional rules are imposed that were not contemplated by the parties or if important negotiated terms of the contract are rewritten or even invalidated by applicable law. Although this risk exists in all contracts, the pitfalls are particularly acute in international transactions.

It is critical for American lawyers involved in international technology transactions to understand the rules that govern the infrastructure of international technology agreements. What is an international agreement? What are the limitations of choice of law or forum, and the scope of extraterritorial rules? What international conventions or treaties apply to the transaction? What are best practices in cross-border licensing transactions? This chapter seeks to address these types of issues.

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§11.2 II. INTERNATIONAL AGREEMENTS AND THE PRINCIPLE OF "TERRITORIALITY"

An agreement will be international or "cross-border" in nature unless both parties are resident in a single country and unless all elements of the relationship of the parties and the terms of the contract are contained only within that state or jurisdiction. If that is not the case, and in particular if the technology or rights are being transferred from the country of origin to another jurisdiction or are being used in another jurisdiction, the principles set forth in this chapter will be relevant and will normally control the transaction.

Whether the national laws of a particular jurisdiction will be applicable to a particular contract is determined by a rule known as the *principle of territoriality*. This is the animating doctrine behind many issues concerning the scope and enforceability of rights and obligations in international technology contracts. (For purposes of this chapter, references to a "state" or "jurisdiction" refer to a national jurisdiction or territory.) Conceptually there are six grounds for territorial jurisdiction, and it is important to recognize their potential application in any intellectual property agreement.

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§11.3 A. Subjective Territoriality

The first ground is known as *subjective territoriality,* when the forum state imposes laws for conduct that wholly or partially originates or occurs within its territory. This principle has been applied, for example, to pierce the corporate veil and impute conduct of a corporate subsidiary in the territory to the extraterritorial parent company on the basis of ownership and control. See, *e.g., Europemballage Corp. & Continental Can Co., Inc. v Comm'n,* Case 6/72, 1973 ECR 215, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61972J0006&lg=en; *Imperial Chem. Indus. Ltd. v Comm'n,* Case 48/69, 1972 ECR 00619, 1972 ECJ CELEX Lexis 2 (the *Dyestuffs* case), available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61969J0048&lg=en. See Restatement (Third) of the Foreign Relations Law of the United States §402 (1987). The Restatement (Third) has been cited repeatedly as authority by California courts. See*, e.g., Renoir v Redstar Corp*. (2004) 123 CA4th 1145, 1150 n1, 20 CR3d 603.

Subjective territoriality is the key concept underlying the validity and enforceability of patents and other intellectual property rights in the country of origin and for the enforcement of contracts being performed within the territory. An example is the Electronic Commerce Directive issued by the European Commission, which provides that the law governing most e-commerce services in those jurisdictions will be determined based on the place where the services are being performed. See EU Directive 2000/31/EC (June 8, 2000), available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32000L0031&model=guichett.

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§11.4 B. Objective Territoriality

The second primary ground for jurisdiction is *objective territoriality,* when a state attempts to govern or limit conduct that occurs outside of its territory but that is directed into the state or intended to have a substantial effect within its territory. This concept is also known as the *effects principle* or the *purposeful availment doctrine*. In this regard, the Restatement takes the position that a state may exercise jurisdiction based on effects in the state when the effect or intended effect is substantial and the exercise of jurisdiction is reasonable. See Restatement (Third) of the Foreign Relations Law of the United States §403 (1987). See, *e.g., Calder v Jones* (1984) 465 US 783, 79 L Ed 2d 804, 104 S Ct 1482; *Purdue Research Found. v Sanofi-Synthelabo, S.A.* (7th Cir 2003) 338 F3d 773, 787 (breach of research and development contract).

The European Community competition laws are a prime example of the *effects principle* when applied to non-European parties to an agreement. These laws are discussed in more detail in §§11.52-11.72. Another example of the principle of objective territoriality is the recent case of Yahoo! France, in which the French court held that Yahoo! should be barred from offering Nazi memorabilia on the Internet in France because the allegedly objectionable behavior was directed at French citizens and therefore sufficiently directed at the jurisdiction to permit the state to take action. *Yahoo! Inc. v La Ligue Contre Le Racisme et L'Antisemitisme* (9th Cir 2006) 433 F3d 1199; *LICRA and UEJF v Yahoo! Inc. and Société Yahoo! France* (Tribunal de grande instance de Paris, Nov. 20, 2000), available at http://www.lapres.net/yahen11.html.

NOTE: The principles of subjective territoriality (conduct within the territory) or objective territoriality (conduct directed at the territory or having a substantial effect in the territory) in particular can adversely affect the rights and obligations of a party to an international technology licensing or distribution agreement.

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§11.5 C. Nationality Principle

The third principle establishing jurisdiction is the concept of *nationality,* by which a state prescribes rules regarding conduct by a national of that state or a person or entity domiciled or resident there, without regard to where the conduct itself occurs. This principle is illustrated, for example, by various federal statutes governing the actions of U.S.-based corporations in other countries, such as the federal Foreign Corrupt Practices Act (FCPA) (15 USC §§78dd-1-78dd-3). The concept of virtual domicile or residence has also asserted itself in electronic commerce, such as in rem jurisdiction for trademark and service mark disputes with domain name holders in the judicial district in which the domain name is registered. See Anticybersquatting Consumer Protection Act of 1999 (ACPA) (15 USC §§1125(d), 1129).

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§11.6 D. Additional Territoriality Principles

The fourth jurisdictional ground is known as the *protective principle,* when there is deemed to be a public policy or inherent need from the perspective of the forum state to protect itself or its government or its citizens or the claimant because of unfair or threatening conduct occurring outside of the territory. See generally *U.S. v Peterson* (9th Cir 1987) 812 F2d 486, 493. The fifth ground for territoriality jurisdiction is known as the *passive nationality* or *passive personality principle,* when the forum state asserts jurisdiction over conduct for the benefit or protection of particular claimants who are affected by the conduct and who are nationals of the state. The final form of territoriality principle is referred to as *universal jurisdiction,* under which there is held to be an inherent and universal right of a state to act in cases of serious crimes such as slavery, piracy, genocide, or other violations of human rights. Restatement (Third) of the Foreign Relations Law of the United States §404 (1987). In all cases, the exercise of jurisdiction must be reasonable. Restatement (Third) of Foreign Relations Law §403(1).

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III. CHOICE OF LAW; CHOICE OF FORUM

§11.7 A. Enforceability of Choice of Law Clauses

The use of choice of law and choice of forum (forum selection) clauses in international agreements represents an effort by private parties to affect or limit the application of the territoriality principles discussed in §§11.3-11.6 to their relationship. It is essential that the parties to the agreement consider in their negotiations the specific benefits and burdens of selecting a particular choice of law and forum for their disputes, and that they understand the inherent limitations of choice of law and choice of forum clauses. The general application of these choice of law and forum selection principles is discussed in §§11.8-11.18. For further discussion of the enforceability of choice of law and choice of forum clauses in California, see California Law of Contracts §§5.44-5.55 (Cal CEB 2007).

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§11.8 1. General U.S. Choice of Law Rule

The general rule in the United States is that a choice of law clause in an international contract will be given effect even if the law is of a foreign jurisdiction, unless shown to be unreasonable under the circumstances. *Bremen v Zapata Off-Shore Co.* (1972) 407 US 1, 12, 32 L Ed 2d 513, 521, 92 S Ct 1907 ("The choice of that forum was made in an arm's-length negotiation by experienced and sophisticated businessmen, and absent some compelling and countervailing reason it should be honored by the parties and enforced by the courts"); *Richards v Lloyd's of London* (9th Cir 1998) 135 F3d 1289, 1297.

California similarly has a strong policy favoring the broad enforcement of choice of law provisions in most contracts under the rule of *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330. In *Nedlloyd Lines,* the California Supreme Court enforced a contractual choice of Hong Kong law for both interpretation of the contract and determination of the causes of action based on the relationship created by the contract. For further discussion of *Nedlloyd Lines*, see California Law of Contracts §5.54 (Cal CEB 2007). See also *Discover Bank v Superior Court* (2005) 36 C4th 148, 173, 30 CR 3d 76; *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 103 CR2d 320.

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§11.9 2. Exceptions to Choice of Law Rule

There are a number of exceptions that may substantially limit the enforceability of choice of law clauses without regard to the parties' intent. One general common law exception is that the parties' choice of law will not be upheld if the chosen state has no "substantial relationship" to the parties or the transaction and there is no other reasonable basis for the choice made. See Restatement (Second) of Conflict of Laws §187(2) (1989). See also *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 465, 11 CR2d 330. In several states, however, this exception has been eliminated by statute for certain types of commercial contracts. For example, in California, CC §1646.5 validates a choice of California law even if the contract or the transaction does not bear a reasonable relationship to California, provided that the contract relates to a transaction with a value of at least $250,000. New York (see NY Gen Oblig Law §5-1401), Delaware, and Texas have comparable statutes.

A choice of law provision will also be unenforceable if the contract (or relevant clause) would violate the fundamental public policy of another jurisdiction with a substantially greater interest in the issue being determined—for example, if a party attempts to use a contractual choice of law to avoid application of a consumer protection statute of the other jurisdiction. See, *e.g., Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 915, 103 CR2d 320; *Nedlloyd Lines B.V.,* 3 C4th at 466. A leading example of a statute embodying the public policy exception is Bus & P C §16600, regarding covenants not to compete. Section 16600 provides that "[e]very contract by which anyone is restrained from engaging in a lawful profession, trade, or business is to that extent void" as a matter of public policy. The statute therefore invalidates covenants not to compete when the covenant restrains a party from pursuing an entire business, trade, or profession. See Bus & P C §16600. See, *e.g., Hill Med. Corp. v Wycoff* (2001) 86 CA4th 895, 901, 103 CR2d 779. California case law holds that §16600 represents a fundamental public policy of the state; therefore, a California court will apply the statute to void noncompete covenants even if the parties have made a contractual choice of law of another jurisdiction. See, *e.g., Scott v Snelling & Snelling, Inc.* (ND Cal 1990) 732 F Supp 1034, 1039.

Other examples of the public policy exception in California include specific statutory prohibitions on the use of out-of-state choice of law clauses for certain classes of contracts. See, *e.g.,* Com C §1301(c); Bus & P C §20040.5. In California and other states, broad disclaimers of warranties or limitations of liability may also be unenforceable as against public policy. See, *e.g.,* CC §§1542, 1668, 1793. In addition, a choice of law clause will not be respected if inclusion of the clause in the agreement was the product of fraud or overreaching by one of the parties. See CC §§1567, 1572-1575. Further, the clause will not be enforceable if one of the parties would effectively be deprived of its day in court if the clause were enforced. See, *e.g., Carnival Cruise Lines, Inc. v Shute* (1991) 499 US 585, 113 L Ed 2d 622, 111 S Ct 1522; *Richards v Lloyd's of London* (9th Cir 1998) 135 F3d 1289, 1294.

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§11.10 3. Issue-by-Issue Determination Required

Under California conflict of law principles, a separate choice-of-law determination must be made with respect to each issue in the case. *S.A. Empresa de Viacao Aerea Rio Grandense v Boeing Co*. (9th Cir 1981) 641 F2d 746; *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 920, 103 CR2d 320; *Application Group v Hunter Group* (1998) 61 CA4th 881, 896, 72 CR2d 73. Accordingly, the parties' choice of law may be applicable to some but not all provisions of an agreement.

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§11.11 4. Conflicts of Law Rules of Forum State

The particular forum in which the claim or suit is brought often determines whether the choice of law clause in the contract will be enforceable, assuming there is a proper basis for jurisdiction. In the United States, the enforceability and scope of a contractual choice of law clause are generally not decided under the law specified in the clause, but rather under the conflicts of law rules of the forum state (which may be the laws of another country). *Batchelder v Kawamoto* (9th Cir 1998) 147 F3d 915, 918 (applying federal common law to find Japanese choice of law provision enforceable). See also *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330 (applying California law, based on Restatement (Second) of Conflict of Law §187 (1989), to find that Hong Kong choice of law was enforceable).

Federal courts in California have also held that in diversity cases the conflicts of law rules of the forum state will determine which law is applicable. *Mail Boxes, Etc., USA, Inc., v Considine* (9th Cir, July 11, 2000, No. 99-35901) 2000 US App Lexis 16185 (unpublished opinion). This underscores the significance of the choice of forum clause in the contract (see §§11.16-11.18) and of a potential strategic decision to initiate a declaratory relief action or similar proceeding to secure a favorable forum if there are perceived risks associated with the choice of law clause.

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5. European Union Choice of Law Rules

§11.12 a. Brief History of European Union

The European Community and later the European Union were established by a series of treaties among the member European countries, customarily named for the respective cities in which the treaties were signed. The European Community is a distinct legal and governmental entity originally created in 1957 by the treaty establishing the European Economic Community (EEC). This treaty (known as the "Treaty of Rome," which is entirely separate from the Rome Convention discussed in §11.13) was adopted for the purpose of establishing a single unified market for the free movement of goods, persons, services, and capital among the member states. The Treaty of Rome was later amended, and the EEC name was shortened to the European Community (EC) in connection with the adoption of the Treaty on European Union (Maastricht Treaty) effective November 1, 1993, which established the European Union (EU).

The EC presently functions as one of the three "pillars" of the European Union, with the other pillars being common foreign and security policies and police and judicial cooperation in criminal matters. The member countries of the EC as of October 2007 are Austria, Belgium, Bulgaria, Cyprus (Greek area), Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. The treaties under which the EC and the EU were founded are available at the EUR-lex website, http://eur-lex.europa.eu/en/treaties/index.htm.

A proposed treaty establishing a constitution for Europe (TCE), referred to as the European Constitution, would have ended the current three-pillar system and eliminated the legal distinction between the EU and the EC. However, ratification of the TCE was voted down in referendums in France and the Netherlands in 2005. More recently, all of the member states have reached accord on the terms of a new "Reform Treaty," which was signed in December 2007 and is being circulated for ratification. If ratified, the Reform Treaty would come into force in 2009. Under the Reform Treaty (expected to be called the "Lisbon Treaty"), the European Union would replace and succeed the European Community as a legal person.

Given these pending developments and for ease of reference, the terms "EU" and "European Union" are used in the remainder of this chapter to refer to both the European Community and the European Union, as the case may be, and the term "EU Treaty" is used to refer to the Treaty of Rome as amended, except where the specific form of citation or the context otherwise requires.

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§11.13 b. EU Choice of Law Rules; Rome Convention

Choice of law rules similar to the U.S.-law principles discussed in §11.11 exist in the European Union under the Convention on the Law Applicable to Contractual Obligations (1980) (Rome Convention), with some important exceptions. The full text and a summary of the Rome Convention is available at http://www.wipo.int/treaties/en/ip/rome/.

Under the Rome Convention, a contract in the European Union is generally governed by the law chosen by the parties, whether or not it is within a member state. Rome Convention, arts 2, 3(1). Certain classes of contracts are excluded under these rules, including many employment agreements. Rome Convention, art 6. To the extent that the parties have made no effective choice of law, under the Convention the contract will be governed by the law of the country with which it is most closely connected. Rome Convention, art 4(1). The choice of law will not be applicable under the Convention, however: (1) if there are mandatory laws regarding the subject matter in an EU forum state with a close connection with the contract, taking into account the nature and purposes of such laws; or (2) if the mandatory laws of the forum state require the use of the laws of the forum state irrespective of the law chosen under the contract. Rome Convention, art 7. As under U.S. rules, the choice of law will also be invalid if application of those laws would be considered manifestly incompatible with the public policy ("ordre public") of the EU forum state. Rome Convention, art 16. Further, choice of law provisions in consumer contracts for goods or services are not enforceable if (1) the consumer is deprived of protective laws of the state of habitual residence, and (2) the contract is effected by advertising or direct solicitation by another party in the state, or the other party has other specified material contacts in the state of residence. Rome Convention, art 5(2). This approach is generally similar to the doctrine of nexus in the United States.

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§11.14 6. Claims of Third Parties; Noncontractual Claims

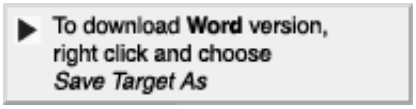
There are inherent limitations on the scope of the parties' choice of law clause, even if the clause is otherwise enforceable. These limitations can be especially problematic for international technology licensing and distribution agreements.

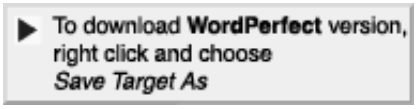
Third party claims. A contractual choice of law binds only the parties to the contract. Claims by third parties for infringement or other third party claims therefore will not be subject to the choice of law or the choice of forum in the contract. See *Paracor Fin., Inc. v General Elec. Capital Corp*. (9th Cir 1996) 96 F3d 1151, 1165 ("A choice-of-law clause, like an arbitration clause, is a contractual right and generally may not be invoked by one who is not a party to the contract in which it appears").

Noncontractual claims. Noncontractual claims of the contracting parties, such as fraud, tort, or statutory claims under unfair competition laws such as Bus & P C §17200, may also fall outside a choice of law clause, depending on how the provision is drafted. California law requires an analysis of the interests of states involved to determine the law that most appropriately applies to each issue. See, *e.g., Sutter Homes Winery, Inc. v Vintage Selections, Ltd.* (9th Cir 1992) 971 F2d 401, 407. The use of specific words in the choice of law provision can be determinative. For a choice of law provision to govern tort or other noncontractual claims arising incident to the agreement, the express language of the choice of law provision must be sufficiently broad to encompass the entire relationship between the contracting parties. In this regard, U.S. courts have distinguished between clauses stating that the choice of law shall govern the "validity, construction and enforcement of the contract" or that the agreement "shall be construed and enforced" under the law of the designated state—which is held not to include tort or other noncontract claims—and clauses stating that the choice of law shall control all claims "arising out of or relating to" the contract—which is held to cover all claims of the parties incident to the relationship. See, *e.g., Medical Instrument Dev. Labs. v Alcon Labs*. (ND Cal, Aug. 10, 2005, No. C-05-1138 MJJ) 2005 US Dist Lexis 41411.

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§11.15 7. Form of Choice of Law Clause





The national laws of relevant jurisdictions can also have a profound effect on the choice of law in relation to the subject matter of the contract, as discussed further in §§11.19-11.28. Taking into account these considerations, an example of a more deliberate and comprehensive choice of law clause for an international technology license is as follows:

This Agreement and all of the rights and obligations arising out of or relating to this Agreement or any other relationship of the parties shall be governed by and construed and enforced in accordance with the laws of _ _[*jurisdiction*]_ _, provided that the scope and validity of any patent or patent application shall be governed by the substantive laws of the country of the patent or patent application, and provided further that Sections _ _[*number*]_ _ on export controls and _ _[*number*]_ _ on arbitration shall be governed by the federal law of the United States, including but not limited to the Federal Arbitration Act, 9 U.S.C. §1 et seq., in each case without reference to conflicts of law principles.

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§11.16 B. Choice of Forum

Each of the parties to an international technology agreement has a clear interest in selecting a specific forum for the resolution of their disputes. The law of the forum state will determine enforceability of the choice of law clause in the first instance (see §11.11). It is also obvious for any number of reasons that litigating the contract dispute in California, rather than in Italy, Hong Kong, or India for example, could materially change the relative benefits and burdens of the proceeding for each of the parties.

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§11.17 1. Enforceability of Forum Selection Clauses

"Choice of forum" provisions in international contracts are subject to similar rules for enforceability as choice of law provisions. Under the principles set forth in *Bremen v Zapata Off-Shore Co.* (1972) 407 US 1, 32 L Ed 2d 513, 92 S Ct 1907 (superseded by statute on other grounds), a choice of forum clause in an international agreement will be considered prima facie valid and enforceable unless it is unreasonable under the circumstances. For these purposes a forum selection clause generally will be unreasonable only if (1) its incorporation into the contract was the result of fraud, undue influence, or excessive bargaining power; (2) the selected forum is so gravely difficult and inconvenient that the complaining party will for all practical purposes be deprived of its day in court; or (3) enforcement of the clause would violate a strong public policy of the forum in which the suit is brought. See *Holland Am. Line, Inc. v Wartsila N. Am., Inc*. (9th Cir 2007) 485 F3d 450, 457.

Under California law, forum selection clauses limiting suits under the contract to a court that otherwise has subject matter jurisdiction over the matter will be upheld if the contract was arm's-length and enforcement of the clause would not be unreasonable. *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 495, 131 CR 374. The forum selection clause operates as an express consent to personal jurisdiction. *Nobel Farms, Inc. v Pasero* (2003) 106 CA4th 654, 658, 130 CR2d 881. Further, choice of forum clauses in contracts involving at least $1 million of consideration that include a California choice of law clause and a consent to the jurisdiction of California courts are enforceable by statute in the state. See CCP §410.40. For further discussion of choice of forum clauses, see California Law of Contracts §§5.44-5.50 (Cal CEB 2007). Venue selection clauses, however, are not enforceable in California. *Arntz Builders v Superior Court* (2004) 122 CA4th 1195, 1202, 19 CR3d 346.

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§11.18 2. 2005 Hague Convention on Choice of Court

In 2005, the Hague Conference on Private International Law concluded a new Convention on Choice of Court Agreements (Hague Convention 37) in an effort to rationalize choice of forum provisions in international commercial agreements. The Hague Convention is available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98. Article 3 of the Hague Convention 37 provides that an exclusive choice of forum by the parties will be honored if the contract is not void under the laws of the forum state, and that there is a presumption of exclusivity in the choice of forum for these purposes. Hague Convention 37, art 3. Under the Hague Convention, in general, if the parties designate an exclusive choice of forum in writing, all other courts of the member states have no jurisdiction over the matter and must decline to hear the case. In addition, the judgment of an exclusive choice of court will be recognized and enforced in the courts of the other member states. Hague Convention 37, arts 3, 6.

NOTE: As of January, 2008, the Hague Convention had not yet been ratified by the United States.

The terms of the Hague Convention are highly relevant for international intellectual property-related agreements. The Convention specifically includes within its scope contract claims under licenses, distribution agreements, joint ventures, and other contracts if intellectual property licenses or assignments are required for performance. Therefore, from a commercial perspective, the Hague Convention is strongly biased in favor of a negotiated choice of forum by the parties.

The exclusions from the Convention, however, are of equal importance and underscore the principle of territoriality and the rule of substantive national law. Article 2(2) of the Hague Convention 37 excludes from its choice of forum rules: (1) matters involving a determination of the validity of intellectual property rights other than copyrights and related rights; (2) infringement claims except for copyright and related rights, other than infringement proceedings that are brought or could have been brought for a breach of contract between the parties to the agreement relating to such rights; (3) competition or antitrust matters; and (4) tort claims not arising out of contract. In this connection, the Convention distinguishes between an issue that is considered only a "preliminary question" in a contractual matter and one that is the "object of the proceedings" (see Hague Convention 37, art 2(3)), *e.g.,* whether the question has to do with a breach of a license of an intellectual property right rather than the validity or infringement of the underlying right itself. It is important to note that matters involving the validity or infringement of copyrights are considered within the choice of forum rules under the Convention.

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§11.19 IV. TERRITORIAL NATURE OF SUBSTANTIVE INTELLECTUAL PROPERTY RIGHTS

Intellectual property rights are inherently territorial in nature and exist on a country-by-country basis. Therefore, the ownership and scope of intellectual property rights such as patents, copyrights, trademarks, and trade secrets are not governed by the choice of law of the parties, but generally will be determined in accordance with the territoriality principle by the substantive national laws of the country of *origin* or the country where the rights are to be *performed or enforced*. These national laws thus determine all questions regarding the subject matter and scope of the intellectual property rights, the owner of the rights, the degree of protection from third parties, the validity and enforceability of the rights, and similar substantive matters. For example, under the Convention on the Law Applicable to Contractual Obligations (1980) (Rome Convention), discussed in §11.13, a contractual choice of law clause does not extend to issues concerning the manner of performance or the steps necessary to cure a failure to perform, both of which are governed by the law of the country where the performance occurs. Rome Convention, art 10(2).

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§11.20 A. Who Is the Owner?

In all cases, it is essential for the parties to focus on and understand the substantive national laws governing the intellectual property rights covered by the parties' agreement and the limitations imposed by those laws. These issues are critical partly because the aggrieved party in any subsequent dispute will usually seek to enforce its intellectual property rights in the other party's territory. The effect of differing national intellectual property laws may be quite complex in practice. All persons deemed to be the "owners" of the technology in question under the applicable national laws therefore must be identified and bound by the license or transfer agreement, or by ancillary consents or waivers.

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§11.21 1. Which Nation's Law Is Applicable?

To illustrate, an international copyright license is subject to the strict doctrine in many jurisdictions (such as Germany) that the laws of the protecting country (*i.e.,* the jurisdiction in which the intellectual property is being used and protection is being sought) will determine the substantive rights of the parties regarding the work. Other countries (such as France) use a combined approach, which determines the initial ownership of the work based on the country of origin and the right to protect the work based on the country of use. It is therefore possible for a work to have different owners in different jurisdictions.

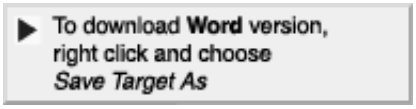
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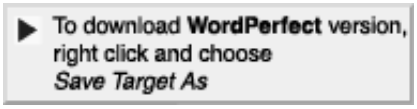
§11.22 2. Moral Rights

The issues may be complicated further by the doctrine of inalienable moral rights, which vest in the developer or author at the time of creation of a work under national law. The doctrine is a common feature of intellectual property laws outside the U.S. Moral rights or "droit morale" are separate and apart from the economic rights associated with copyrights, and can prevent a complete transfer or licensing of ownership or use as intended by the parties. Moral rights primarily include the right of attribution of the individual as the developer or author of the work and the right of integrity to prevent prejudicial changes to the work. Moral rights may also include rights of nondisclosure and withdrawal. The Berne Convention for the Protection of Literary and Artistic Works (Paris Text 1971) (Berne Convention) expressly recognizes moral rights of attribution and integrity of works, stating that "[i]ndependently of the author's economic rights, and even after the transfer of the said rights, the author shall have the right to claim authorship of the work and to object to any distortion, mutilation or other modification of, or other derogatory action in relation to, the said work, which would be prejudicial to his honor or reputation." Berne Convention, art 6. The Berne Convention is available at http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html. This principle can become attenuated to the point of absurdity: in one recent case a performance artist smashed a Marcel Duchamp statue with a hammer at the Centre Pompidou in Paris, then claimed he had moral rights in his "derivative work" that prevented the museum from restoring the damaged object against his interests.

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§11.23 3. Moral Rights Clause





Especially in licensing or other transfers of copyrighted software or artistic works, it is crucial for the parties to understand the effect of any moral rights in the relevant jurisdictions on the transaction. It is advisable for the contract to include a form of moral rights clause so that the transferee will obtain, *to the extent possible,* any rights that might otherwise remain with the transferor or a third party following the transfer. In addition, counsel should make an internal assessment of the extent to which such clauses may not be completely effective under the laws of the particular jurisdiction.

The clause should include a requirement that the transferor obtain a specific license, or waiver of any assertion, of moral rights from the individual developer or employee. Following is an example of such a clause:

To the fullest extent permitted by law, _ _[*Assignor/Licensor*]_ _ hereby assigns and waives all rights of attribution, integrity, disclosure, and withdrawal, and any other rights that may be known as or referred to as "moral rights" or any similar or other rights with respect to attribution of authorship or integrity of the Works, that _ _[*Assignor/Licensor*]_ _ may have under any applicable law, whether under copyright, trademark, unfair competition, defamation, right of privacy, contract, tort, or other legal theory (collectively "Moral Rights") that _ _[*Assignor/Licensor*]_ _ may possess in the Works; provided however that to the extent such assignment or waiver is not effective, then _ _[*Assignor/Licensor*]_ _ hereby (1) ratifies and consents to any act or omission that may be taken with respect to such Moral Rights by or for the Company and its successors and assigns at any time; (2) irrevocably licenses each and all such Moral Rights to the Company and its successors and assigns on an _ _[*exclusive/nonexclusive*]_ _, perpetual, and fully paid up basis with full rights of assignment, transfer, and sublicensing; and (3) agrees and covenants not to assert any such Moral Rights to any extent and to confirm in writing any such ratifications, consents, licenses, and covenants from time to time as requested by the Company or its successors or assigns. _ _[*Assignor/Licensor*]_ _ shall obtain equivalent assignments, waivers, and covenants in writing for the benefit of the Company and its successors and assigns from any employee or contractor of _ _[*Assignor/Licensor*]_ _ who may possess or claim any of such Moral Rights, to the fullest extent permitted by law.

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§11.24 4. Multilateral Treaties and Directives

Certain categories of intellectual property are governed by multilateral treaties or laws, in addition to or in place of national laws. For example, EU Directive 91/250/EEC (May 14, 1991) on the legal protection of computer programs, known as the "Software Directive," sets forth standards for the protection of computer programs that have the effect of limiting the moral rights principle. The Software Directive provides that "[w]here a computer program is created by an employee in the execution of his duties or following the instructions given by his employer, the employer exclusively shall be entitled to exercise all economic rights in the program so created, unless otherwise provided by contract." See EU Directive 91/250/EEC, art 2, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31991L0250:EN:NOT.

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§11.25 B. What Is Protected?

The scope of protection of the intellectual property rights under the agreement must be determined for all relevant jurisdictions. One complication resulting from the territorial nature of substantive intellectual property rights is the doctrine of *absolute novelty* under the patent regimes of most countries outside the U.S. In general, U.S. patent law permits a company to commercially exploit or publicly disclose its invention for up to 1 year before filing a patent application for the invention. See 35 USC §102(b). After this 1-year period, the company will be barred from all patent rights in the United States if the patent has not been filed within that time.

Most other countries, however, do not recognize any grace period before the patent application is filed. In those jurisdictions, including Europe and Japan, a single public use, publication, or disclosure of the invention before the filing of the patent can destroy patentability, under the theory that the invention itself has become "prior art," which defeats the novelty required for patent protection. Under European Patent Office rulings, the invention will be considered "public" if any person not bound by an express obligation of confidentiality could obtain and understand the relevant product or information. See http://www.european-patent-office.org. In addition, the United States is a "first to invent" system, under which the patent is awarded to the person who was the first to invent the method or process, while in many other countries the inventor who is first to file may be entitled to the patent.

The grant of a patent license based on a U.S. patent or patent application and corresponding Patent Cooperation Treaty (June 17, 1970, as later amended) (PCT) (available at http://www.wipo.int/pct/en/texts) filings will not be valid in other territories even if fully enforceable in the United States unless national patents are later granted in those countries for the licensed technologies. Technology licenses primarily based on patent applications are particularly at risk under these systems.

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§11.26 C. Improvements; Grantbacks

The challenges presented by cross-border ownership and use of substantive intellectual property rights are compounded further when a technology agreement provides for a license of existing rights and also covers joint or separate improvements of the licensed intellectual property, such as grantbacks of improvements by the licensee or multiple tiers of sublicensees. A provision for mandatory grantbacks by a licensee, especially if tied to limitations on the licensee's use of the technology outside of the license, may violate applicable competition or other national laws.

A case in point is the new intellectual property regime established by the People's Republic of China (PRC) effective January 1, 2002. Under current rules, transactions for the *importation* of foreign technologies into the PRC—whether under a technology license or through a joint venture with a domestic partner—are extensively regulated. The relevant contracts must be filed with the government and must contain statutory representations and warranties, including clauses to the effect that the licensor is the rightful owner or licensee of the imported technology and that the licensor shall be responsible for all infringement claims. Further, licensors are prohibited from imposing certain restrictive terms, such as (1) ancillary conditions not indispensable to the licensed technology, (2) limitations on improvements to the technology or use of the improvements by the licensee, (3) restrictions on using competing technologies, and (4) unreasonable restrictions on sourcing of materials, production, export distribution of the products, and certain other matters.

Under the PRC laws, improvements to imported technologies will generally be owned by the party who has made the improvements without regard to any contrary agreement of the parties, and the assignment of rights in patents or patent applications by a PRC company to a foreign party will be subject to government approval. Possible alternatives recommended by some practitioners to blunt the effects of these rules on the licensor are the use of a separate research and development agreement or joint venture in addition to the principal technology license, transfer of the technology in stages, or the use of single-source foreign components for production in China.

It is essential for the parties to conduct appropriate due diligence to determine exactly what rights the licensor has to license, and then to negotiate the scope of the license grant meticulously, including warranties and indemnification obligations. The licensor may well have relevant patent or other intellectual property rights only in the United States and a few other jurisdictions, even if the license is purported to be worldwide. A licensor in this position will commonly endeavor to limit its *warranties* of enforceability and noninfringement to third party claims under U.S. or other applicable law, but agree to broader *indemnification* against such claims. This avoids a breach of contract by the licensor while still allocating the economic risks of an infringement claim or nonenforcement between the parties.

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§11.27 D. Other Substantive National Laws

Other substantive national laws may also limit or void material contract terms by operation of law. Depending on the jurisdiction, either as a matter of law or public policy, there may be restrictions on contract clauses purporting to limit products liability or other claims; restrictions on sourcing, production, or distribution; privacy and data protection requirements; requirements under national competition or antitrust laws and environmental laws; and import and export controls. In each case, it is necessary to determine whether the domestic laws of the relevant jurisdiction will adversely affect the power of the parties to enter into important provisions of the contract. For example, the European Union has issued directives imposing products liability without fault for defective goods, under which the producer of the goods must compensate for the death or personal injury of an individual or for damage to property without regard to negligence. See EU Directive 85/374/EEC (July 25, 1985) (available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31985L0374:en:html), as amended by EU Directive 99/34/EC (May 10, 1999) (available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:141:0020:0021:en:pdf). Contractual clauses limiting or excluding liability toward the injured person are prohibited. EU Directive 85/374/EEC, art 12. There are also recent EU environmental directives regarding the use of hazardous substances in electrical and electronic equipment and the disposal of electronic equipment and certain components. See EU Directive on Waste Electrical and Electronic Equipment 2003/108/EC (Dec. 8, 2003) (available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_345/l_34520031231en01060107.pdf), amending EU Directive on Waste Electrical and Electronic Equipment 2002/96/EC (Jan. 27, 2003) (available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_037/l_03720030213en00240038.pdf); EU Directive on the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment 2002/95/EC (Jan. 27, 2003) (available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_037/l_03720030213en00190023.pdf).

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§11.28 E. "Franchise" Issues

National franchise laws may also have an unintended effect on cross-border trademark licensing transactions, including transactions involving a grant of an exclusive or nonexclusive trademark license as part of a larger intellectual property or product distribution agreement. Under the most common rule in the United States, including under California law, a "franchise" exists when (1) the transaction includes a license of trademarks or other commercial symbols of the franchisor to be used with the business of the franchisee; (2) the franchisor exercises substantial control over or provides substantial assistance to the franchisee, or alternatively prescribes a marketing plan or system in substantial part for the franchisee; and (3) a franchise fee is required to be paid to the franchisor, which can be in the form of royalties or other consideration. See, *e.g.,* 16 CFR §436.1(h); Corp C §31005.

Similar concepts are used in the European Union. See European Commission Guidelines on Vertical Restraints 2000/C291/01 (Oct. 13, 2000) ¶¶199-201 (available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2002:122:0001:0048:EN:PDF); *Pronuptia de Paris v Schillgalis*, Case 161/84, (1986) ECR 353, 1986 ECJ Celex Lexis 89, http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=61984J0161. In practice, the statutory definitions of a "franchise" are very broad and vague, and it is entirely possible for an international trademark license to be reclassified as an "inadvertent" or "accidental" franchise agreement under these standards, despite the parties' intentions. In that event, the licensor may be subject to potential civil and criminal liability for statutory noncompliance, and various negotiated terms of the agreement, including the right to terminate or renew and the choice of law and forum, may be invalidated or limited in effect.

Laws governing franchise relationships have been enacted recently in a number of European countries, in particular, in France, Spain, and Italy. See http://www.eff-franchise.com.

For example, the French Loi Doubin, art L, 330-3 (Dec. 31, 1989) covers any trademark or trade name license granted in exchange for a commitment of exclusivity or quasi-exclusivity by the licensee, provided the business has some nexus to France. The law requires the delivery of an extensive written disclosure document by the licensor prior to signing. Failure to comply can subject the licensor to fines and the risk of claims for damages and retroactive cancellation of the agreement with restitution of royalties received. There are no express exceptions under the Loi Doubin for agreements, such as distribution agreements or partnerships, that fall within the broad terms of the law but are not generally considered franchise agreements.

The Italian law, Law No. 129/04 (Apr. 27, 2004), is also broadly written. It basically defines a franchise agreement as a contract in any form granting a licensee the right to use intellectual property rights related to trademarks, patents, copyrights, know-how, or other subject matter, in exchange for the payment of royalties, if the licensor is obligated to transfer its know-how and provide assistance and if the object of the agreement is to have the franchisee join a system of franchisees in the territory for the marketing of goods or services (including master franchisees). See Law No. 129/04, arts 1(1), 3(4). Under these rules, the term of the agreement must be of sufficient duration for the licensee to recoup its investment, and in all events no less than 3 years.

The scope of jurisdiction and enforceability of choice of law provisions under these laws is currently uncertain. In one recent French decision since criticized (*Cohen v Sté Punto*, JCP E 2002), the Court of Appeal of Paris held that the Loi Doubin was not applicable to a franchise to be operated in France when the contract had a Spanish choice of law clause, on the ground that there was no applicable public policy exception. The regulations issued in 2005 by the Italian government for the implementation of its franchise law state that the scope of the regulations are limited to agreements that are governed by Italian law according to Italian conflicts of law rules. See Regulation Setting up Rules on Franchise, art 1(2) (Sept. 2, 2005).

There are also franchise laws in Australia, Belgium, Brazil, China, the European Union, Indonesia, Japan, Kazakhstan, Lithuania, Malaysia, Mexico, Romania, Russia, South Korea, Sweden, Taiwan, Venezuela, Vietnam, the province of Ontario and certain other provinces of Canada, as well as the United States. See CCH Business Franchise Guide, International Laws and Regulations, ¶7000.

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V. EXPORT AND IMPORT CONTROLS

§11.29 A. U.S. Export Controls

The United States government and the governments of a number of other jurisdictions impose extensive regimes of export controls on transfers and licenses of technologies and products to foreign persons or entities. These regulations can be a serious trap for companies and their counsel, and must be considered in detail in any cross-border intellectual property transaction in order to avoid material violations of law. As of January, 2007, the U.S. government maintained comprehensive economic embargoes against Cuba, Iran, Sudan, Syria, and certain designated terrorist persons or groups; and also maintained partial embargoes, including programs relating to Rwanda and Iraq, consistent with international obligations. See 15 CFR pt 746. Exports to certain other countries (as of July 2007, North Korea, Angola, and Rwanda) are subject to various specific licensing restrictions. See 15 CFR pts 738, 746.

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§11.30 1. Export Administrative Regulations (EAR)

The initial stage of an export controls assessment is to determine which U.S. governmental agency has jurisdiction over the technology or product to be exported by the client. The primary export control rules are contained in the Export Administration Regulations (EAR) administered by the U.S. Department of Commerce, Bureau of Industry and Security (BIS). See 15 CFR pts 730-774. Certain specific types of technology exports will involve other federal agencies, as follows:

- The Office of Foreign Asset Controls (OFAC) of the U.S. Department of the Treasury administers embargoes prohibiting the export of U.S. origin products to certain countries and also transactions with individuals and entities identified by the OFAC in its "Specially Designated Nationals and Blocked Persons List," available at http://www.treas.gov/offices/enforcement/ofac/sdn. In this connection OFAC implements three separate programs designed to combat the proliferation of weapons of mass destruction under its Weapons of Mass Destruction Trade Control Regulations.
- The Office of Defense Trade Controls (ODTC) of the U.S. State Department has jurisdiction over military and defense-related items on the U.S. Munitions List pursuant to the International Traffic in Arms Regulations (ITAR). See 22 CFR pts 120-130.
- The U.S. Nuclear Regulatory Commission and the U.S. Department of Energy have export controls on commodities relating to nuclear materials. See 10 CFR pt 110.
- Finally, the U.S. Patent and Trademark Office (PTO) maintains its own export controls under the authority of BIS (as discussed below), permitting otherwise restricted technologies to be exported under certain circumstances when required to obtain patent protection in the foreign country.

Under the EAR, controlled technologies and products cannot be exported, reexported, or exported from abroad to listed countries or to or from prohibited individuals or organizations, unless the transaction is licensed by the federal government or subject to a regulatory exception. The lists issued by the BIS include (1) the Denied Persons List of individuals and entities that have been denied export privileges—any dealings with such persons violating the terms of their denial order are prohibited; (2) the Unverified List—the presence of parties on this list are considered "red flags" in a transaction; and (3) the Entity List of parties whose presence in the transaction will require a specific export license in addition to any other licensing requirements. See http://www.bis.doc.gov/ComplianceAndEnforcement/ListsToCheck.htm. Under the EAR, exporters must retain all records in connection with the export for 5 years.

The act of disclosing controlled technologies to a foreign national, either outside the United States or when that person is physically present here, in any form is deemed to be an export to the country of the foreign national. 15 CFR §734.2(b). This can occur, for example, when a U.S. engineer orally discusses technical information on a controlled item during business meetings in Asia, or when a foreign engineer visits California and tours a production facility with controlled technologies. In the latter case, allowing the engineer to view the production facilities or manufacturing processes would be an "export" subject to these regulatory controls.

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§11.31 2. Scope of EAR; Commerce Control List (CCL)

The scope of the EAR extends to commodities, technology, software (including technical information necessary for the "development," "production," or "use" of a product, computer source code, circuit board, or other computer parts), and foreign-origin items being transshipped through the United States. See 15 CFR §734.3. Technical information subject to export controls can take the form of technical data or technical assistance, including instruction, skills training, working knowledge, and consulting services. There are limited exceptions to these rules under the EAR for "publicly available" technology and software and for items within the exclusive jurisdiction of another U.S. government agency, such as OFAC and ODTC.

BIS maintains a Commerce Control List (CCL) (see 15 CFR pt 738) for these purposes, which sets forth a series of classifications for types of technologies or other items subject to export controls. 15 CFR §738.1. The CCL designates all items that are subject to the EAR and assigns to each an Export Control Classification Number (ECCN). The ECCN is a five-digit classification indicating the category and group of each item. The ECCN designation of an item is the primary means of determining what export restrictions are applicable. Because different ECCN classifications apply to a commodity and to the technology or software related to that commodity, different export restrictions may be applicable to the same product. It is not uncommon to have situations where the export of a commodity to a particular country is permitted while the export of the technology associated with that commodity to the same country is restricted or prohibited.

BIS has granted the PTO the authority to license the export and re-export of certain technologies otherwise subject to the EAR when the technology is in the form of a patent application or an amendment. 15 CFR §734.3(b)(1)(v). See 15 CFR §734.10(b). Export authorization from the PTO may be obtained in the form of a foreign filing license in accordance with PTO regulations. See 37 CFR pt 5.

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§11.32 B. Export Control Policies

It is essential for technology companies to implement and maintain an export control policy and compliance program to avoid violations of these regulations. For U.S. law purposes, this effort will require a review and classification under the CCL of the products and technologies produced or sold by the company, to determine whether the products or technologies can be exported without specific restrictions or whether additional compliance measures are necessary. The company should adopt a general export control policy and compliance program, even if none of its product are restricted under the CCL, in order to comply with general export controls on dealing with embargoed countries and prohibited persons.

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§11.33 C. Other Export Controls

The export controls of other countries in which the company conducts business also must be considered in technology transactions. For example, the European Union has a regime for the control of exports of dual-use items, including software and other technologies that can be used for both civil and military purposes, such as goods that can be used for both nonexplosive purposes and the manufacture of nuclear weapons or other nuclear devices. See Council Regulation (EC) No. 1334/2000 (June 22, 2000) on control of exports of dual-use technology, available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2000/l_159/l_15920000630en00010215.pdf. Amending acts to this regulation are available at http://europa.eu/legislation_summaries/external_trade/11029_en.htm. Secondary legislation in various EU member states may impose additional export restrictions on technology transfers and assistance, such as the United Kingdom Export Control Act 2002 (July 24, 2002, effective as of May 1, 2004), available at http://www.opsi.gov.uk/ACTS/acts2002/20020028.htm). See UK Export Control Act 2002, chap 28.

China also has recently adopted new technology export and import regulations that distinguish between unrestricted, restricted, and prohibited technologies. See Technology Import and Export Administrative Regulations of the People's Republic of China (Jan. 1, 2002, State Council of the People's Republic of China); Administrative Measures for Registration of Technology Import and Export Contracts (Jan. 1, 2002, MOFTEC); Administrative Measures on Prohibited and Restricted Technology Imports (Jan. 1, 2002, MOFTEC and SETC). These rules require registration of the contract with the governmental authorities and approval for restricted technology transactions.

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§11.34 D. Import Controls

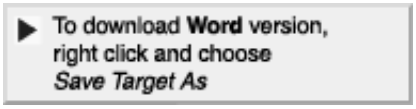
One or more jurisdictions in a technology transaction may also regulate the *importation* of relevant technologies or goods into their territories. Many developing countries impose controls on technology imports on various grounds, such as the protection and promotion of national development and the efficient use of foreign currency reserves. These import control regimes may require the registration and approval of the technology agreements with the applicable government agency in the jurisdiction. More developed countries, including the United Kingdom, France, and Japan, also maintain import control regulations for certain classes of technologies and goods.

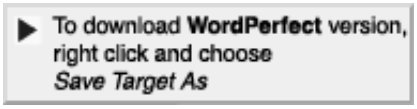
For general summaries of the trade policies of various nations around the world, including both import and export restrictions, see the website of the World Trade Organization: http://www.wto.org/english/tratop_e/tpr_e/tp_rep_e.htm#bycountry.

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Source: Business Law/Intellectual Property in Business Transactions/11 Selected International Issues/§11.35 E. Export Control Compliance Clause

§11.35 E. Export Control Compliance Clause





The parties to a technology agreement would be advised to include express provisions requiring compliance with any export and import controls under applicable law. An example of such a clause follows:

This Agreement is made expressly subject to any export or import laws, regulations, orders, or other restrictions imposed by the United States Government or by any other governmental entity in any relevant jurisdiction on the Licensed Technology or any related information ("Export and Import Laws"). Notwithstanding any other provision to the contrary, Licensee shall comply with all applicable Export and Import Laws at all times during the Term and shall not export or re-export or import or re-import, directly or indirectly, any of the Licensed Technology or related information to or from any jurisdiction to which such export or re-export or importation or re-importation is restricted or prohibited, or as to which any such government or any agency thereof requires an export or import license or other governmental approval at the time of such export or re-export or importation or re-importation, without first obtaining such license or governmental approval.

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§11.36 VI. OTHER RELEVANT UNITED STATES LAWS

Other U.S. federal laws and their counterparts in other jurisdictions may limit or otherwise impact a proposed cross-border technology transaction. These laws include the Foreign Corrupt Practices Act (FCPA) (15 USC §§78dd-1-78dd-3) and various privacy and data protection statutes.

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A. Foreign Corrupt Practices Act

§11.37 1. Potential Liability

The FCPA is an antibribery statute that prohibits any U.S. person or company from corruptly paying or offering to pay anything of value to a foreign official directly or indirectly to assist in obtaining or retaining business. 15 USC §78dd-2(a). The term "foreign officials" is interpreted to include not only government employees but also employees of state-controlled enterprises. 15 USC §78dd-2(h)(2). Further, the statute is not limited to government contracts, but includes the obtaining of any commercial advantage, including regulatory approvals or licenses or reductions in taxes or duties. There is no de minimis exception, and "anything of value" can include cash, gifts, and entertainment whether or not for the direct benefit of the foreign employee. The penalties for violation of the FCRA include substantial fines, imprisonment for up to 5 years, loss of export licenses, and the risk of private litigation. 15 USC §78dd-2(g)(2).

Further, vicarious liability can be imposed under the statute for payments by third persons in connection with the business of the company, if the company knows that the payments will be made or that there is a "high probability" of such payments. See 15 USC §78dd-2(a)(3)(B), (h)(3). As a result, a company can be liable under the FCRA for the bad acts of its local subsidiaries, joint venture partners, agents, and distributors.

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§11.38 2. Defenses; Compliance

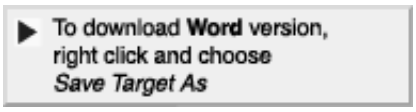
Defenses to alleged violations of the FCPA are narrow. "[R]easonable and bona fide expenditures" are permitted under the statute if *directly* related to the promotion, demonstration, or explanation of products or services, or to performance of the contract with a foreign government or agency. 15 USC §78dd-2(c)(2). In practice, this is interpreted to mean that gifts and hospitality are not permissible if such benefits would "improperly affect" the outcome of the business transaction.

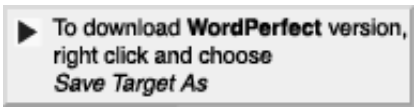
U.S. companies are also permitted to make payments to obtain or expedite "routine government actions" performed in the ordinary course by a foreign official, such as issuance of permits or licenses or processing governmental papers such as visas and work orders. See 15 USC §78dd-2(b). However, routine governmental action for these purposes does not include any decision by a foreign official to award new business or to continue business with a particular company. 15 USC §78dd-2(h)(4)(B). Payments to government officials are also exempted to the extent expressly permitted under the written laws of the local jurisdiction. 15 USC §78dd-2(c)(1). There may also be anticorruption laws in the foreign jurisdiction that require separate compliance.

International technology transactions often involve state-controlled enterprises in many parts of the world, and generally require various interactions with government officials or employees in connection with required approvals, permits, or fees. The company must be fully knowledgeable about the prohibitions of the FCPA and the anticorruption laws of each relevant country, and should establish and enforce internal accounting controls and compliance procedures for monitoring its third party relationships. The U.S. Department of Justice (DOJ) has a Foreign Corrupt Practices Act Opinion Procedure, under which any U.S. company or person may request written advice from the DOJ regarding any proposed business conduct under the antibribery provisions of the FCPA. See 28 CFR pt 80.

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§11.39 3. FCPA Compliance Clause





All international licensing, development, manufacturing, and distribution agreements should contain express covenants requiring compliance with the FCPA and the anti-corruption laws of the relevant jurisdictions. These provisions are especially important if a licensee is permitted to sublicense the technology to third parties. An example of such a clause follows:

_ _[*Licensor/Manufacturer*]_ _ **and** _ _[*Licensee/Distributor/Reseller*]_ _ **each agree that it and its affiliates will fully comply with the United States Foreign Corrupt Practices Act and the anticorruption laws of any other applicable jurisdiction at all times, and will not offer any payment or other gift or promise, or authorize the giving of anything of value, for the purpose of influencing an act or decision of an official of any government or of an employee of any company in order to assist it or any of its affiliate in obtaining, retaining, or directing any business.**

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§11.40 B. Privacy and Data Protection Laws

International licensing or distribution agreements that contemplate the use or exchange of personal information of customers or other third persons must take into account the possible effect of data privacy laws in each of the jurisdictions covered by the agreement. The United States and many other countries, including members of the European Union, Japan, Hong Kong, and Taiwan, have enacted their own data privacy laws to regulate or restrict the transfer or disclosure of categories of personal information.

In the United States, the Federal Trade Commission (FTC) considers it a deceptive and unlawful practice under Section 5(a) of the Federal Trade Commission Act (15 USC §§41-58) for a company to fail to comply with its stated privacy policies or to implement reasonable and appropriate measures to protect sensitive personal information from customers. See, *e.g., In the Matter of Gateway Learning Corp.,* FTC File No. 042-3047, available at http://www.ftc.gov/os/caselist/0423047/0423047.shtm. In addition, specific federal privacy laws have been enacted that target the use and disclosure of personal information in certain sectors of the economy, such financial services, health care, and minors. For example, the Children's Online Privacy Protection Act of 1988 (COPPA) (15 USC §§6501-6506) requires certain online disclosures on websites that collect information from children, including foreign websites that collect information from children in the United States. 15 USC §§6501-6506. See 16 CFR pt 312. See generally the Gramm-Leach-Bliley Act (15 USC §§6801-6809); the Fair Credit Reporting Act (FRCA) (15 USC §§1681-1681x), as amended by the Fair and Accurate Credit Transactions Act of 2003 (FACTA) (Pub L 108-159, 117 Stat 1952). The state of California has also taken a leading role in privacy and data security legislation. For further information on the California legislation, see Internet Law and Practice in California §§9.16-9.18 (Cal CEB 2004).

The European Union issued a comprehensive Directive on the Protection of Personal Data in 1995, which governs the processing, use, and disclosure of personal data in the member states. See EU Directive 95/46/EC (Oct. 24, 1995), available at http://ec.europa.eu/justice_home/fsj/privacy/law/index_en.htm. The Directive establishes individual rights of notice and access, and requires companies possessing protected personal information to notify or register with the local data protection authorities or appoint a local corporate data protection officer. Companies are also required to establish compliance and technical security procedures to prevent loss or unauthorized disclosure of the information. The personal data covered by the Directive further cannot be transferred outside of the European Union without additional safeguards. Personal Data Directive, Arts 25-26(1)-(2). In 2003 the EU issued a separate Directive on Privacy and Electronic Communications concerning the processing of personal data and the protection of privacy in the electronic communications sector, EU Directive 2002/58/EC (July 12, 2002), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002L0058:EN:HTML. The European Commission has issued additional guidelines on standard contractual clauses for the transfer of personal data under the Directive. Commission Decisions 2001/497/EC (Dec. 27, 2004), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0074:0084:en:pdf; 2002/16/EC (Dec. 27, 2001), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002D0016:en:html; and 2004/915/EC (Dec. 27, 2004), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004D0915:EN:HTML.

Japan has also adopted a comprehensive Privacy Law effective April 2005, requiring comparable nondisclosure and security measures.

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VII. ROYALTY ISSUES

§11.41 A. Scope of Royalties

An international patent or other intellectual property license might be structured to require payment of royalties on the *worldwide* sales or revenues of the licensee, even though the rights being licensed are only protected in selected countries by issued patents or other registrations. The licensee therefore would be required to pay royalties for the use of technology in jurisdictions where the licensee would be free to operate but for the license agreement. In this type of case, the argument has been made under U.S. law that requiring worldwide royalties constitutes patent or copyright misuse or other anticompetitive behavior, when the licensor uses excessive market power or leverage against the licensee to coerce worldwide royalties but the licensee has proposed to pay royalties only for the territories in which the rights have been issued. See generally *Zenith Radio Corp. v Hazeltine Research, Inc.* (1969) 395 US 100, 139, 89 S Ct 1562, 23 L Ed 2d 129 (patent misuse exists when the licensor insists that royalties be paid on all products sold by the licensee, regardless of use of the patented technologies, but the licensee has proposed to pay royalties on only the products covered by the licensed patents). See also 35 USC §271(d). On the other hand, royalties based on percentage of sales have been upheld in cases where the licensor and licensee entered into the agreement voluntarily and for their mutual convenience, as part of a bargained-for exchange. See *Engel Indus., Inc. v Lockformer Co.* (Fed Cir 1996) 96 F3d 1398, 1408; *U.S. v Westinghouse Elec. Corp.* (ND Cal 1978) 471 F Supp 532, 545, aff'd in part and re'vd in part on other grounds (9th Cir 1981) 648 F2d 642. Even if a certain method of royalty calculation is considered permissible under U.S. law, the issue could also arise under the national law of the relevant foreign country.

From the licensor's perspective, it may be useful to include a provision in the license agreement stating that the parties have agreed to a worldwide royalty arrangement voluntarily and for their mutual benefit, as the most convenient means of computing the fair value of the license. See, *e.g., Auckerman Co. v Chaides Constr. Co.* (ND Cal 1993) 29 USPQ2d 1054 (upholding a package licensing agreement for the convenience of the parties, when certain of the patents had expired).

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§11.42 B. Tax Withholding on Royalties

Royalties paid under a cross-border intellectual property licensing agreement will often be subject to tax-withholding obligations equal to a percentage of the royalties, as determined by the applicable national law or income tax treaty.

The U.S. Internal Revenue Code imposes a federal income tax of 30 percent, or a lower treaty rate, on foreign persons with respect to "fixed or determinable annual or periodic income," including royalties paid to foreign licensors on patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other similar intellectual property, if such royalties are U.S.-source income. IRC §§871(a)(1)(A), (D), 881(a)(1), (4). Taxable income includes contingent payments from the sale or exchange of such intellectual property. IRC §§871(a)(1)(D), 881(a)(4). Royalties for the use of, or privilege of using, such intellectual property within the United States are considered to be U.S. source income under IRC §861(a)(4). Conversely, royalties payable for the use of the intellectual property outside of the United States are foreign source and not subject to U.S. taxation. IRC §862(a)(4). In general the payor (*i.e.,* the licensee) must withhold the required taxes on the payment of royalties from U.S. sources and remit the taxes to the proper tax authorities. IRC §1441.

Allocation and apportionment of the royalties are necessary for tax purposes when the intellectual property is used both within and outside of the United States. See IRC §863. In this context, the Internal Revenue Service has ruled that royalties on trademark or copyright licenses are foreign-source income not subject to U.S. taxation, regardless of where title passes, when a U.S. person was licensed the right to manufacture the goods in the United States but the goods were distributed and consumed solely within the foreign jurisdiction of the licensor. See Rev Rul 72-232, 1972-1 Cum Bull 276; Rev Rul 68-443, 1968-2 Cum Bull 304.

U.S. licensors may also be subject to tax withholding under the domestic tax regimes of other countries for use or transfer of intellectual property in those jurisdictions.

The effects of tax withholding on royalties is reduced, and in some cases eliminated, by tax treaties between the United States and various other countries. For treaty purposes, intellectual property royalties are generally classified into three separate categories with different withholding rates: (1) industrial royalties for patents, trademarks, trade secrets, know-how, and similar rights, with separate rates under some tax treaties for industrial, commercial, and scientific know-how; (2) motion picture and television copyright royalties; and (3) other copyright royalties for books, recordings, and other works. The reduced withholding rates generally range between zero and 15 percent.

NOTE: For further discussion of U.S. tax issues concerning royalties, see §§10.46-10.56.

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§11.43 C. Collection of Royalties

The United Nations Convention on the Assignment of Receivables in International Trade (2004) (Convention) contains provisions relevant to the payment and collection of royalties under intellectual property agreements involving sublicensing. The text of the convention is available at http://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf. By its terms, the new Convention could permit an intellectual property master licensee to assign its sublicensing royalty receivables to lenders in secured transactions, without regard to any detriment to the licensor or prohibitions on assignment in the license agreement. It remains to be seen how the Convention will be implemented in practice, but these new rules may put licensors at risk in cases where the technology license is exclusive over broad fields of use or covers a substantial territory (such as Asia or Europe), so that the encumbered royalty stream could therefore represent all or substantially all of the expected revenues from the exploitation of the technology. In appropriate situations, it may be advisable for the licensor to enter into direct second-tier licenses with the intended sublicensees, coupled with a corresponding economic sharing arrangement with the master licensee, in order to avoid the risk of unilateral assignment by the licensee of all of the second-tier royalties to its creditor under the new Convention.

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§11.44 VIII. INTERNATIONAL INTELLECTUAL PROPERTY TREATIES

Numerous multinational treaties and conventions have been enacted to harmonize the cross-border treatment of patent rights, copyrights, trademarks, and other intellectual property rights. The main purpose of these treaties is to ensure minimum rights and nondiscriminatory treatment between contracting states with respect to intellectual property, with certain exceptions for national competition laws and rights inconsistent with the public policy of a state. These international treaties add another layer of complexity to the structuring of international technology transactions. A comprehensive index of these treaties can be accessed at the website of the World Intellectual Property Organization (WIPO) at http://www.wipo.int/treaties/en.

The most important international treaties concerning intellectual property rights are:

- For patents, the Paris Convention for the Protection of Industrial Property (1883) as revised and amended (Paris Convention), available at http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html, and the Patent Cooperation Treaty (1970), as amended and modified (PCT), available at http://www.wipo.int/pct/en/texts/;
- For copyrights and related rights, the Berne Convention for the Protection of Literary and Artistic Works (Paris text 1971) as amended (Berne Convention), available at http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html, and the WIPO Copyright Treaty (1996), available at http://www.wipo.int/treaties/en/ip/wct/trtdocs_wo033.html;
- For trademarks, the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (1989) as amended (Madrid Protocol), available at http://www.wipo.int/madrid/en/legal_texts/trtdocs_wo016.html; and
- The World Trade Organization (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights (1994) (TRIPS), available at http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm.

There are also a series of European Union directives dealing with specific intellectual property regimes within the EU, discussed in §11.50. The enforcement of intellectual property rights can also be affected by regional and bilateral treaties between certain countries, such the North American Free Trade Agreement (NAFTA). The text of NAFTA is available at http://www.nafta-sec-alena.org/en/view.aspx?x=343. The main features of the principal treaties and conventions are discussed in §§11.45-11.51.

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§11.45 A. Paris Convention and Patent Corporation Treaty

Under the Paris Convention and the PCT, each member state must grant the same protection regarding patents to nationals or persons domiciled in the other member states as it grants its own nationals and domiciliaries. The treaties establish a right of priority in the case of patents and related rights, so that an inventor filing a regular patent application in one of the member states may also file a form of international patent application and obtain the same priority date. This is a filing priority only and does not affect the substantive review of the patent application. The patent application must still be reviewed by the national patent offices in the relevant jurisdictions, and whether a patent is granted or denied is within the independent discretion of each relevant patent office. As discussed in §11.25, the requirement for multinational review can be problematic for U.S. companies filing within the 1-year bar date applicable in the U.S. but after public disclosure, which implicates the absolute novelty doctrine applicable outside the U.S.

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Source: Business Law/Intellectual Property in Business Transactions/11 Selected International Issues/§11.46 B. Berne Convention

§11.46 B. Berne Convention

Under the Berne Convention, authors must be granted the same protection as nationals of the member state where protection is sought, including certain minimum rights and a minimum term of protection for the copyright. Substantive national law continues to control determinations of ownership of the copyright and any restrictions or preconditions for transfer.

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§11.47 C. WIPO Copyright Treaty

The WIPO Copyright Treaty (1996) supplements the Berne Convention by protecting computer programs and data compilations as literary works under the Berne Convention. It sets forth general standards regarding the right of the authors of computer programs, films, and sound recordings to commercially rent their works to the public. The treaty also includes restrictions against circumvention of technological measures for electronic rights management and the prevention of unauthorized copies.

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§11.48 D. TRIPS Agreement

Under World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the member states of the WTO are required to provide for the substantive national protection of all essential intellectual property rights and to provide treatment for the nationals of other member states that is no less favorable than each member state provides to its own nationals with regard to the protection of intellectual property. TRIPS also establishes a system of enforcement procedures and trade sanctions for combating counterfeiting and piracy of protected technologies and products. Note that, under Article 40 of TRIPS, exceptions are provided for national competition laws and rights inconsistent with the public policy of a member state.

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Source: Business Law/Intellectual Property in Business Transactions/11 Selected International Issues/§11.49 E. Madrid Protocol

§11.49 E. Madrid Protocol

The Madrid Protocol permits a trademark owner to have its trademark protected in the numerous countries comprising the Madrid Union by filing an international trademark application with its own national office. In the U.S., the Madrid Protocol is codified at 15 USC §§1141-1141n.

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Source: Business Law/Intellectual Property in Business Transactions/11 Selected International Issues/§11.50 F. European Union Directives

§11.50 F. European Union Directives

The EU has issued a series of directives in an effort to harmonize certain intellectual property rights laws within the EU, all available at the EUR-Lex website, http://eur-lex.europa.eu/en/index.htm. These directives include the following:

- For copyrights, the Software Directive 91/250/EEC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31991L0250:EN:HTML; the Rental Rights Directive 92/100/EEC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992L0100:EN:HTML; the Term of Protection Directive 93/98/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31996L0009:EN:HTML; the Database Directive 96/9/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31996L0009:EN:HTML; and the Copyright in the Information Society Directive 2001/29/EC, available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2001/l_167/l_16720010622en00100019.pdf;
- For trademarks, the Trade Marks Directive 89/104/EEC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31989L0104:EN:HTML, and the Community Trade Mark Regulation 40/94 (OJ L 11/1);
- For patents, the Biotechnology Directive 98/44, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998L0044:EN:HTML, and several other proposed directives; and
- For designs, the Designs Directive 98/71/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998L0071:EN:HTML.

Recent EU legislation on enforcement in this area includes the Directive on Enforcement of Intellectual Property Rights 2004/48/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003D0022(01):EN:HTML.

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§11.51 G. U.N. Convention on Contracts for International Sale of Goods

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Although not an intellectual property treaty, the United Nations Convention on the International Sale of Goods (1980) (CISG), available at http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html, governs cross-border contracts for the sale of goods, including distribution agreements and licensing agreements with a sales component, in a manner similar to Article 2 of the Uniform Commercial Code. Both written and oral contracts of sale are subject to the Convention. The CISG does not apply to contracts in which the "preponderant" obligations of the party furnishing the goods consists of the performance of labor or other services. CISG, Art 3(2).

The CISG covers various elements of the sales transaction, including strictly enforced notice requirements for the buyer to reject nonconforming or defective goods or obtain indemnity against the seller for third party infringement claims (Arts 39(1), 43(1)), implied warranties of the seller for fitness and conformity of the goods (Art 35) and for noninfringement (Art 42), and rights and exceptions in the event of breach. For further discussion of the CISG, see California Law of Contracts, chap 13 (Cal CEB 2007).

The CISG permits the parties to expressly exclude its application or, subject to certain exceptions, to vary the effect of any of its provisions by contract. CISG Art 6. It is common practice in the United States, as part of a contractual choice of law provision, to exclude application of the CISG in international distribution agreements and other international contracts involving the sale of goods, to prevent the CISG from overriding the parties' express contractual choice of law and producing unintended or unexpected shifts of rights and obligations. Following is an example of such an exclusionary provision:

This Agreement shall not be governed by the United Nations Convention on Contracts for the International Sale of Goods, the application of which is expressly excluded for all purposes.

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§11.52 IX. EU COMPETITION LAWS

No international license or distribution agreement can be properly structured without a careful determination of the effects of competition or antitrust laws applicable to the transaction. Any company operating or transacting business in the European Union must possess a thorough understanding of EU competition laws to avoid potentially serious adverse consequences. Standard contract provisions in U.S. licenses or distribution agreements can run materially afoul of these rules unless care is exercised.

The main EU competition laws are presently set forth in Articles 81 through 89 of the EU Treaty, available at http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/12002E.html, in a series of regulations and guidelines promulgated under the Treaty by the European Commission, and in the judicial decisions of the Court of First Instance and the Court of Justice of the European Community. Each of the member states of the EU also may enact its own national competition laws to the extent not in conflict with the EU Treaty. The European Commission is the main governmental agency responsible for the enforcement of the EU competition laws. The national competition authorities of the member states also have enforcement authority in cooperation with the Commission.

If the licensing or distribution transaction is conducted or implemented within any member state of the European Union in material part, the EU competition laws can apply to the transaction under the territoriality principle regardless of the choice of law of the parties or whether or not any of the parties are European entities. In this context the European Court of Justice has upheld the extraterritorial application of the EU competition rules to non-EU companies when those parties either exported products from outside the EU directly to purchasers within the EU, or conducted business indirectly within the EU through branches, subsidiaries, agents, or other entities. See *Woodpulp,* Case C-89/85 [ECJ 1993]; *Imperial Chem. Indus. Ltd. v Comm'n,* Case 48/69, 1972 ECR 00619, 1972 ECJ CELEX Lexis 2 (the *Dyestuffs* case), available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61969J0048&lg=en.

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A. EU Treaty, Article 81: Agreements Between Undertakings

§11.53 1. Prohibited Agreements: Article 81(1)

In furtherance of the single-market initiative at the core of the European Community, Article 81(1) of the EU Treaty prohibits agreements between "undertakings" that may affect trade between EU member states and that have as their object or effect the prevention, restriction, or distortion of competition within the European Union. Such agreements include without limitation ones that (EU Treaty, Art 81(1)):

> (a) directly or indirectly fix purchase or selling prices or any other trading conditions; (b) limit or control production, markets, technical development, or investment; (c) share markets or sources of supply; (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; or (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

The burden of proof is on the European Commission to establish an infringement of Article 81(1).

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§11.54 a. Two or More Parties

An agreement or concerted practice between *two or more* independent undertakings is necessary under Article 81 of the Treaty, and a single economic entity acting on a unilateral basis cannot violate these rules. See *Bayer AG v Comm'n* (CFI 2000) Case T-41/96, 2000 ECR II-3383, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61996A0041:EN:HTML; *Centrafarm BV v Sterling Drug* (ECR 1974) Case 15-74, 1974 ECJ Celex Lexis 110, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=61974J0015; *Viho v Comm'n,* Case C-73/95 P, 1996 ECR I-5457, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61995J0073:EN:NOT. "Undertakings" can include companies, joint ventures, individuals, and other entities, including governments under certain circumstances. For these purposes, controlled subsidiaries and genuine agents are not considered separate entities but part of a "single economic unit." However, the existence of a prohibited agreement can be inferred from a course of concerted practices or acquiescence between parties. See *Sandoz Prodotti Farmaceutici SpA v Comm'n* (ECJ 1990), Case C-277/87, 1990 ECR I-00045.

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§11.55 b. Object or Effect of Market Distortion

The agreement or concerted action will fall within Article 81(1) if either its object or its effect is prevention, restriction, or distortion of competition within the European Community. When an agreement does not have an impermissible object, a complex analysis of the relevant markets (including both the relevant product market and the relevant geographic market) and the market shares of the parties will be necessary to determine the anticompetitive effect of the agreement. It must be stressed that the Commission can apply an extremely narrow view of the relevant market under the circumstances, resulting in high market shares for the parties, possible disqualification from applicable block exemptions (see §§11.59-11.71), and a finding of unlawful effect under Article 81(1).

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§11.56 c. Vertical and Horizontal Agreements

Article 81 is applicable to both vertical and horizontal agreements, and the classes of agreements subject to Article 81 include licensing and distribution agreements within the EU jurisdiction. See, *e.g., Windsurfing International v Comm'n,* Case 193/83, 1986 ECR 611 (patent licenses); *Nungesser v Comm'n,* Case 258/78, 1982 ECJ CELEX Lexis 8, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61978J0258&lg=en (license of plant rights).

The core case demonstrating these principles is *Etablissements Consten S.a.R.L & Grundig-Verkaufs-GmbH v Comm'n* (*Consten and Grundig*) Joined Cases 56 and 58-64, 1966 ECJ CELEX Lexis 8, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=61964J0056, where the European Court of Justice held that distribution agreements that prevent all parallel trade in the contract goods have as their object the restriction of competition and violate the single market objective under Article 81. In that case, Grundig, a German manufacturer of radios, tape recorders, and other electronic equipment, appointed Consten as its exclusive distributor for France. As part of their distribution agreements, Consten agreed not to sell competing products, to order a minimum quantity of Grundig products, to stock accessories and spare parts, and to provide after-sales services. In return, Grundig agreed not to sell the products directly into France and imposed export and re-export restrictions on all distributors in other member states. Consten also registered the Grundig trademark in France. Consten thus had absolute territorial protection from competition, because the combination of its exclusive distribution rights and ownership of the trademark prevented other persons from selling Grundig products in France, either actively or passively. Under the circumstances, the European Court of Justice held that the agreements clearly had as their object the unlawful distortion of competition in the EC. It was considered irrelevant that the parties were in a vertical rather than a horizontal relationship. In this regard, the court stated that "[c]ompetition may be distorted within the meaning of Article [81(1)] not only by agreements which limit it as between the parties, but also by agreements which prevent or restrict the competition which might take place between one of them and third parties." 1966 ECJ CELEX Lexis at 339.

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§11.57 d. Consequences of Article 81(1) Violation

The consequences of violating the restrictions of Article 81(1) may be quite severe. The unlawful contractual provisions are automatically void under Article 81(2) of the EU Treaty. The European Commission also has the authority to impose substantial monetary fines and a broad range of other sanctions for violations of the treaty, including "behavioural or structural remedies which are proportionate to the infringement." See Counsel Regulation (EC) No. 1/2003, Art 7(1). In one recent example, the European Commission imposed a 2.5 million Euro fine plus legal fees on a large non-EU electronics manufacturer and its subsidiaries for alleged violations of the competition laws through a series of obligations imposed on its European distributors. Further, the national competition authorities can separately impose sanctions for violations of EU competition laws or related national laws in their jurisdiction, and the manner in which these laws can be enforced may differ. For example, under the UK Enterprise Act 2002, an individual held to have engaged in anticompetitive behavior under the Act may be barred from being a corporate director of another company within the UK for as long as 15 years. See UK Enterprise Act 2002, ch 40, §204. Private third party actions for relief for violations of Article 81(1) are also possible.

Given these consequences and the broad discretion exercised by the European Commission in its interpretation and enforcement of the competition laws, parties to technology or distribution agreements that are or may be subject to EU jurisdiction should structure their agreement either to fall outside of Article 81(1) entirely or to qualify under the terms of the general exemption of Article 81(3) or one of the block exemptions issued by the Commission for certain classes of agreements (see §§11.59-11.71).

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2. Exemptions

§11.58 a. Article 81(3)

Article 81(3) of the EU Treaty excepts certain agreements from a finding of anticompetitive behavior. To satisfy the terms of Article 81(3), two positive and two negative requirements must be met (Treaty, Art 81(3)):

(1) The agreement must contribute to an improvement in production or distribution of goods or the promotion of technical or economic progress;

(2) Consumers must get a fair share of the benefits;

(3) The agreement must not impose on undertakings restrictions that are not indispensable; and

(4) The agreement must not afford the possibility of substantially eliminating competition.

See *Metropole Television v Comm'n* (CFI 2001) Case T-112/99, 2001 ECR II-02459, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=61999A0112. Unless a block exemption is applicable (see §§11.59-11.71), the private parties have the burden of proof to demonstrate that their agreement fulfils each of the conditions for exemption in Article 81(3).

The European Commission has published guidelines on the general application of Article 81(3) of the Treaty (2004/C 101/08), available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/c_101/c_10120040427en00970118.pdf. As discussed in §§11.59-11.71, the Commission has also issued a series of "block exemptions" from Article 81(1) establishing safe harbors for certain classes of transactions, including technology transactions and product distribution agreements. Compliance with the conditions of the germane block exemption should be a prime objective of any technology or distribution arrangement having EU attributes.

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§11.59 b. Block Exemption for Technology Transfer Agreements

A block exemption for technology transfer agreements is available under Commission Regulation (EC) No. 772/2004 (TTBER) (Technology Transfer Block Exemption Regulations) (Apr. 27, 2004) (available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004R0772:en:html) and Commission Guidelines on Technology Transfer Agreements (2004/C 101/02) (Apr. 27, 2001) (available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:101:0002:0042:en:pdf). The objective of the TTBER is to promote technological innovation and efficiencies within the European Community, and the terms of the exemption can be understood in that context. The block exemption is granted to technology transfer agreements related to the production of contract products. TTBER, Art 2. The exemption guidelines for the TTBER are extensive and provide detailed explanations of the elements of the exemption.

For these purposes, the term "technology transfer agreements" includes patent licenses, know-how licenses, and software copyright licenses, or any combination during the term of protection or confidential status. TTBER, Arts 1(1)(b), (d), 2. The term also includes both straight licenses and assignments if part of the risk of exploitation of the technology remains with the transferor, in particular, if any consideration is contingent on future production or revenues. See TTBER, Art 1(1)(b). Neither patent or technology pools nor master license agreements are included in the TTBER, because the pool or master licensee is not expected to produce any contract products, but rather to sublicense the technology to others. However, the technology sublicenses granted by the patent pools or by the master licensee to sublicensees are included in the block exemption if the sublicensees are to manufacture the products.

Trademarks and artistic copyright licenses are not considered technology transfers and are not within the TTBER or any other subject-matter-specific block exemption. They are therefore subject to review under the general terms of Article 81(3). See §11.58. Supply and distribution agreements are also not covered by the TTBER, but are covered under the separate block exemption for vertical agreements. See §§11.66-11.69.

The TTBER has certain other conditions for eligibility, discussed in §§11.60-11.65.

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§11.60 (1) Market Share Thresholds

The combined market share of parties who are not competitors (such as parties solely under a vertical license) cannot exceed 30 percent of the relevant technology and product markets, and the combined market shares of competing parties (such as those under a horizontal license) cannot exceed 20 percent of such markets. TTBER, Art 3. Agreements between parties below the combined threshold are generally deemed procompetitive and not able to affect trade between member states, unless there are hardcore restraints in the contract. See TTBER, Art 3.

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§11.61 (2) No Hardcore Restrictions

The TTBER has a blacklist of "hardcore" restrictions in technology transfer agreements that will disqualify the entire transaction from the technology block exemption. TTBER, Art 4. See also http://ec.europa.eu/comm/competition/general_info/h_en.html (definition of "hardcore" restrictions). These hardcore restrictions are a very common trap for U.S. licensing parties. Conceptually, the TTBER has separate categories of hardcore restrictions as between competitors (*e.g.,* under a horizontal license; see TTBER, Art 4(1)) and agreements between noncompetitors (*e.g.,* under a vertical license; see TTBER, Art 4(2)). The hardcore restrictions for agreements between competitors are more or less strict depending on whether the parties have entered into a reciprocal license or a nonreciprocal one-way license. Agreements between noncompetitors tend to be in the form of a downstream license for the use of technology in a particular territory or field, and there is generally more flexibility in the types of restrictions permitted in such vertical license agreements.

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§11.62 (3) Restrictions on Sales to Exclusive Territories or Customers; Active and Passive Sales

The primary objective of the EU competition laws is to establish an open market system and free movement of goods and services within the Community. The block exemptions under Article 81 are therefore not applicable when the parties structure their agreement to unduly restrain sales of products or services within the Community as a whole. Accordingly, the TTBER lists a series of hardcore restrictions on sales that will disqualify an agreement from the block exemption. These rules differentiate between "active" and "passive" sales, concepts that are essentially foreign to U.S. licensing practice. For these purposes, the term "active sales" generally means to affirmatively approach specific customers or customer groups in the exclusive territory of another distributor, or exclusive customer groups of the other distributor, or to establish an outlet in another distributor's exclusive territory. The term "passive sales" generally means to respond to unsolicited requests from individual customers for delivery of goods or services. For these purposes, general advertising or promotions, including use of the Internet to advertise or sell products, is generally considered to be a form of passive sales. Commission Guidelines on Vertical Restraints (2000/C 291/01, ¶50) available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=32000Y1013(01)&model=guichett. The hardcore sales restrictions under the TTBER include the following (see TTBER, Art 4):

- Any ban between competitors on "active" or "passive" sales into the territory or to the customers of the other party or its licensee are generally deemed hardcore if the agreement is reciprocal in nature.
- In the case of noncompetitors, a restriction on active sales into the exclusive territory or customers of the other party or its licensee is permissible.
- A restriction between noncompetitors on passive sales is also permitted for an initial period of time deemed reasonably necessary to establish market share in the territory. It must be stressed that a common clause prohibiting a licensee from selling licensed products over the Internet without any time limitation will also be a hardcore restriction on *passive* sales and will disqualify the license agreement from the technology transactions block exemption.
- For both competitors and noncompetitors, it is a hardcore restriction to prevent active or passive selling by a retail licensee.
- These standards are applied differently to some extent in the case of "selective distribution systems." Under a selective distribution system, the supplier chooses the distributors for the contract goods or services on the basis of objective criteria relating to the technical qualifications and expertise of the distributor and its staff, which are not applied in a discriminatory manner to all potential resellers.

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Source: Business Law/Intellectual Property in Business Transactions/11 Selected International Issues/§11.63 (4) Pricing Restrictions

§11.63 (4) Pricing Restrictions

Minimum resale price maintenance for contract products is considered a prohibited hardcore restriction for competitors and noncompetitors. The use of maximum or suggested resale prices for contract products is hardcore if between competitors, and permissible if the agreement is between noncompetitors.

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§11.64 (5) Production and Output Restrictions

Restrictions on production or output by one party within the territory of the other party are hardcore restrictions if contained in a reciprocal license between competitors; but in general are permissible in a nonreciprocal license between competitors or a license between noncompetitors. The granting of exclusive territories for production and output of contract products is permissible. Maximum quantity limitations are also permissible unless the licensor is imposing them with a series of licensees or in reciprocal agreements with competitors.

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§11.65 (6) Noncompetition Restrictions

Restrictions on use of the third party technology are permissible for competitors and noncompetitors. However, a ban on the right of a party to develop or use its own technologies will be a hardcore restriction for competitors and potentially hardcore for noncompetitors.

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§11.66 c. Block Exemption for Vertical Agreements

The European Commission has also established a separate block exemption for vertical agreements for the sale or purchase of contract goods or services at different levels in the production or distribution chain. See Commission Regulation (EC) No. 2790/1999 (Dec. 22, 1999) (Verticals Regulation), Art 2(1), available at http://eur-lex.europa.eu/pri/en/oj/dat/1999/l_336/l_33619991229en00210025.pdf. The Verticals Regulation applies to both goods and services agreements, and to goods supplied for resale and for use. Verticals Regulation, Art 1. The agreements covered by the Verticals Regulation include without limitation distribution agreements, supply and purchasing agreements, selective distribution systems, and franchises. The Verticals Regulation has its own market-share thresholds and hardcore restrictions.

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§11.67 (1) Vertical Market Share Thresholds

The block exemption does not apply to vertical agreements between competitors, unless the agreement is nonreciprocal and either (a) the buyer has total annual turnover (revenues) not exceeding 100 Million Euros, or (b) the parties do not compete as manufacturers of contract goods or providers of competitive services. Verticals Regulation, Art 4.

In addition, the supplier cannot have more than a 30-percent market share in the relevant market for the contract goods or services, or in the case of vertical agreements with exclusive supply obligations, the market share of the distributor in the relevant market cannot exceed 30 percent. Verticals Regulation, Art 3.

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§11.68 (2) Vertical Hardcore Restrictions

Hardcore restrictions under the Verticals Regulation block exemption include the following (Verticals Regulation, Art 4):

(a) Minimum or fixed resale price restrictions.

(b) Any ban on active sales into another territory or to customers unless there has been the grant of an exclusive territory or channel of distribution to another supplier or distributor. In that event a ban on *active* sales into other exclusive territory is permissible.

(c) Any ban on *passive* sales into another territory or to other customers without regard to the grant of exclusive territories or distribution channels to other suppliers or distributors. Note that all Internet sales are generally considered to be passive sales, and territorial limitations on Internet sales will breach the exemption.

(d) Any ban on either active or passive sales to other authorized distributors or to end users in a selective distribution system, including persons at different levels of distribution. This prohibition is intended to protect the right of an authorized dealer or distributor network to freely transfer inventory between the members of the network. A prohibition on sales to unauthorized distributors in such a system is permissible.

(e) Restrictions on sales of spare parts to end users and other service providers. A restriction on the right of the distributor to resell components provided by the supplier to others for use in manufacturing the same type of goods is permissible.

It is also permissible for purposes of the block exemption to the contract to restrict sales by a wholesale distributor to end users only. Verticals Regulation, Art 4.

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§11.69 (3) Verticals Noncompetition Clauses

The Verticals Regulation does not per se disqualify the parties from the block exemption in the event that one of the parties enters into a covenant not to compete under the agreement. Instead, the Regulation carves out certain restrictions without affecting the rest of the exemption. Article 5 of the Regulation provides that the following direct or indirect noncompete obligations will generally not qualify for the vertical agreement block exemption (Verticals Regulation, Art 5):

(a) Noncompetition clauses with an indefinite duration or a stated duration of more than 5 years during the term of the agreement.

(b) Posttermination noncompetition obligations not to manufacture, purchase, sell, or resell goods or services, unless the restriction (a) relates to goods or services that compete with the contract goods or services, (b) is geographically limited to the location of the office of the distributor or licensee during the term, (c) is indispensable to protect the know-how transferred by the supplier to the distributor, *and* (d) has a duration of no more than 1 year following termination. All of these conditions must be met for the posttermination noncompete clause to qualify for the block exemption.

(c) Any direct or indirect obligation causing the members of a selective distribution system to not sell the brands of specific competing suppliers.

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§11.70 d. De Minimis Exemption

The Commission separately has published the Notice on Agreements of Minor Importance (2001/C 368/07) (Dec. 22, 2001), available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2001/c_368/c_36820011222en00130015.pdf, which exempts agreements considered to not "appreciably restrict competition" under Article 81(1) because of the small market shares held by the parties. Under this de minimis exemption, the parties' aggregate market share cannot exceed 10 percent of any of the relevant markets if the contracting parties are actual or potential competitors in any such markets. Notice on Minor Agreements, ¶7(a). If the parties are not actual or potential competitors, then the market share of each of the parties to the agreement cannot exceed 15 percent of any of the relevant markets. Notice on Minor Agreements, ¶7(b). If the relevant market competition is restricted by the cumulative effect of agreements between different suppliers or distributors, then the market share threshold is reduced to 5 percent for both competitors and noncompetitors. Notice on Minor Agreements, ¶8.

The de minimis exemption is not applicable under the Notice on Minor Agreements if the agreement contains any of a series of hardcore restrictions comparable to the "blacklist" used in the Verticals Regulation discussed in §§11.66-11.69. See Notice on Minor Agreements, ¶11.

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§11.71 e. Other Technology Block Exemptions

The European Commission has also established two other block exemptions under Article 81(3) with potential application to specific classes of technology transactions:

- Block Exemption for Specialization Agreements (European Commission Regulation 2658/2000 (Nov. 29, 2000), available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2000/l_304/l_30420001205en00030006.pdf), which deals with certain kinds of joint ventures; and
- Block Exemption for Research and Development Agreements (European Commission Regulation 2659/2000 (Nov. 29, 2000), available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=32000R2659), for pure R&D agreements under which the parties have no license to produce or distribute contract products or services with the developed technologies.

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§11.72 B. EU Treaty Article 82: Abuse of Dominant Position

Article 82 of the EU Treaty separately bans unilateral anticompetitive abuse by companies with a dominant position in the relevant market in a substantial part of the European Union, similar to the concept of monopolistic practices under U.S. law pursuant to the Sherman Anti-Trust Act (15 USC §§1-7). Unilateral actions by a dominant undertaking—including such actions in the context of a technology transfer agreement—can subject the party to sanctions even if such actions would be permissible under Article 81 were the party not in a dominant position in the relevant market. These forms of abuse can include, without limitation, imposing unfair fees or pricing, limiting production or technical development to the prejudice of consumers, requiring different terms from equivalent transactions with other trading partners, and imposing supplemental obligations with no connection to the subject matter of the agreement. EU Treaty, Art 82.

For these purposes, an entity has a dominant position in the relevant market when it has the power to act independently in the market to an appreciable extent without regard to its competitors or customers. Determination of the existence of a dominant position in a relevant market requires sophisticated economic analysis. It is possible for a company to own a series of intellectual property rights that control a sufficiently important part of a market that the European Commission or third parties may claim that the company has a dominant position in that market. The recent judgment against Microsoft Corporation by the EU Court of First Instance is primarily grounded on allegations of abuse of its dominant position in the software markets under Article 82 of the EU Treaty. See *Microsoft Corp. v Comm'n,* Case T-201/04 (2007), available at http://curia.europa.eu (click on "en" at the bottom of the page, then type "Microsoft v Commission" in the "Names of parties" field). See also *Hoffman-La Roche v Comm'n*, Case 102/77, 1978 ECJ Celex Lexis 104, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61977J0102:EN:HTML; *Istituto Chemioterapico Italiano S.p.A. & Commercial Solvents Corp. v Commission*, Joined Cases 6 and 7-73, 1974 ECJ CELEX Lexis 33, available at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61973J0006&lg=en. It is also possible for two or more companies to have collective dominance in the market by parallel behavior.

If one or more of the parties to a technology license or distribution agreement has or may have a dominant position in the relevant market (which could be very narrowly defined by the European Commission or national competition authorities), the transaction will be susceptible to challenge under Article 82 in addition to Article 81 of the EU Treaty.

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§11.73 X. COMMERCIAL AGENCY DIRECTIVE

Another potentially serious trap for U.S. contracting parties in the European Union is the termination compensation regime established by the 1986 Council Directive on self-employed commercial agents, EU Directive 86/653/EEC (Commercial Agency Directive), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31986L0653R(01):EN:HTML, and enabling legislation and regulations adopted by various national jurisdictions.

Under the Commercial Agency Directive, persons within the EU who are granted authority to negotiate the sale or purchase of goods on behalf of another person, or to negotiate and conclude transactions in the name of the other person, are considered to be "commercial agents" under these rules. EU Directive 86/653/EEC, Art 1(1). It is possible for a sales representative or export distribution agreement to be recharacterized as a commercial agency relationship depending on the freedom of the representative or distributor to act under the agreement. Recharacterization is a particular risk in dual distribution situations where the local distributor facilitates or aids in direct sales by the manufacturer or supplier into the relevant distribution channel in the territory. Such an agreement may be oral or implied from the conduct of the parties, and agency status under the directive can be confirmed retroactively by acceptance or ratification of the relevant acts.

The Commercial Agency Directive and implementing national laws requires that the manufacturer or supplier is required to compensate the commercial agent on the expiration or termination of the agreement, either as a "goodwill indemnity" for increases in business or as "damages" for termination of the contract. EU Directive 86/653/EEC, Art 17. The goodwill indemnity can equal as much as one times the average annual compensation earned by the person during the term (Art 17(2)(b)), although different jurisdictions in the EU use different methodologies to compute the compensation payment, in addition to any termination damages.

The enabling legislation for the directive uniformly provides that the national laws of the jurisdiction and the European Union will govern these such agreements without regard to any choice of law of the parties.

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Intellectual Property Licenses in Bankruptcy

David H. Kennedy

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§12.1 I. INTRODUCTION

This chapter discusses certain issues that arise at the intersection of bankruptcy law and intellectual property law when a licensor or licensee of intellectual property rights becomes a debtor in a case under Title 11 of the United States Code (the Bankruptcy Code). There is a surprising degree of uncertainty with respect to a number of these issues because the relevant provisions of the Bankruptcy Code either have not been the subject of any published court decisions or have been interpreted in published decisions with conflicting results. This uncertainty may also be due in part to the divergent nature of intellectual property law and bankruptcy law and the lack of common understanding among intellectual property practitioners and bankruptcy lawyers regarding how the two areas of law should interrelate. As a result of this uncertainty, licensors and licensees are not currently able to structure license transactions with a clear understanding of how their respective rights and obligations will be affected in a bankruptcy context.

In a licensor bankruptcy, areas of uncertainty or confusion include the extent to which a licensee, following rejection of the license agreement by the licensor under Bankr C §365, can preserve its license rights: (1) in existing foreign patents and copyrights that are included in the licensed intellectual property (see §12.31), (2) under a contingent license that has not become effective as of the commencement of the bankruptcy case (see §12.37), (3) in postpetition improvements and other developments made after the commencement of the bankruptcy case, including patents that issue on patent applications pending at the time of commencement of the case (see §§12.33-12.35), and (4) under a trademark license, including a trademark license that is an integral part of a "bundled" license of patents, copyrights, or trade secrets (see §§12.29, 12.38). It is also unclear in the context of a licensor bankruptcy whether the automatic stay of Bankr C §362 applies to the exercise of rights under Bankr C §365(n) to compel a debtor or a third party to provide licensed intellectual property (or embodiments thereof), including the triggering of a release of source code under a source code escrow agreement (see §12.45).

In a licensee bankruptcy, the issues that are uncertain or not generally understood include: (1) the extent to which Bankr C §365(c)(1) precludes the assumption or assignment by a debtor licensee of an intellectual property license without the licensor's consent; (2) whether the rights granted under an intellectual property license that cannot be assumed under Bankr C §365(c)(1)(A) are exercisable before rejection of the license and whether such rights can "ride through" a Chapter 11 case over the licensor's objection (see §12.75); (3) whether a licensor under an intellectual property license can terminate the license upon a bankruptcy filing by the licensee, notwithstanding the general unenforceability of bankruptcy ipso facto termination clauses under Bankr C §365(e)(1) (see §§12.59-12.62); and (4) the extent to which a licensor of trade secrets may continue to enforce a confidentiality clause following rejection of the license agreement under which trade secrets were disclosed (see §12.77).

This chapter begins with a general overview of the bankruptcy process. See §§12.2-12.17. Next, this chapter discusses the bankruptcy and intellectual property law issues arising in a licensor bankruptcy, along with strategies for mitigating potential risks. See §§12.18-12.57. This chapter then addresses the bankruptcy and intellectual property law issues that arise in a licensee bankruptcy, along with strategies for mitigating potential risks. See §§12.58-12.78. Finally, §§12.79-12.89 include sample clauses intended to improve the position of a licensor or licensee when the other party to a license agreement becomes a debtor in a bankruptcy case.

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II. OVERVIEW OF BANKRUPTCY PROCESS

§12.2 A. Introduction

The Bankruptcy Code has five chapters under which different types of bankruptcy cases may be commenced. The two chapters of general application to corporations and other business entities are Chapter 7 and Chapter 11. This chapter generally addresses the effect of a bankruptcy filing on an intellectual property license from the standpoint of a Chapter 11 filing, although much of the following discussion applies equally in a Chapter 7 case, except that a bankruptcy trustee, rather than the debtor in possession, is the representative of the bankruptcy estate in a Chapter 7 case.

In a Chapter 7 case, the trustee takes title to and assumes control over all of the debtor's assets upon commencement of the case and proceeds to liquidate the assets for the benefit of creditors in accordance with their legal priorities. In rare cases, the trustee may seek an order under Bankr C §721 permitting the trustee to operate the debtor's business in the ordinary course pending the trustee's sale of the business as a going concern. In contrast, except in unusual circumstances when a trustee is appointed by the bankruptcy court, the debtor in a Chapter 11 case retains ownership and control of its assets (in such capacity, the debtor is referred to as the "debtor in possession"). Thus, on a bankruptcy filing, the debtor's assets and business are either controlled by the debtor in its capacity as debtor-in-possession or by a trustee. The debtor in possession generally has the same rights and powers and the same duties as a trustee. 11 USC §1107(a). For convenience, the person controlling the debtor's assets and business following the filing of a bankruptcy petition will be referred to in this chapter as the debtor.

Chapter 11 is designed to enable a debtor to rehabilitate through a restructuring of its balance sheet and a reorganization of its business as a going concern. Although many Chapter 11 cases end with the liquidation of the debtor, a filing under Chapter 11, in theory, serves the important policy objectives of preserving jobs, enabling the debtor to maximize the recoveries available for creditors, and possibly producing a return for shareholders. To achieve these objectives, Chapter 11 permits the debtor to operate in the ordinary course pending the negotiation of a plan of reorganization (see 11 USC §§1121-1123) that is subject to confirmation by the bankruptcy court if various confirmation requirements are satisfied (see 11 USC §1129). Chapter 11 provides the debtor (or other plan proponent) with significant flexibility in how the debtor's balance sheet may be restructured and its business may be reorganized, subject to specific requirements designed to ensure that certain rights of creditors are respected. The main requirements are that creditors' claims be treated under the plan in a manner consistent with their legal priorities and that each creditor is entitled to distributions under the plan that is at least equal to what the creditor would have received if the debtor had been liquidated in a Chapter 7 case instead. The requirement that claims be treated in a manner consistent with their legal priorities can be waived by affected creditors voting (in the requisite majorities) to accept the plan. See generally 11 USC §1129.

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§12.3 B. Involuntary Bankruptcy Cases

If the debtor has 12 or more creditors, three or more creditors holding aggregate unsecured claims of at least $13,475 that are not contingent or the subject of a bona fide dispute regarding liability or amount may commence an involuntary case. 11 USC §303(b)(1)-(2). The debtor is entitled to timely contest an involuntary filing. 11 USC §303(d). If the involuntary filing is timely contested, the bankruptcy court will enter an "order for relief" (thereby approving the filing of the involuntary petition) if it determines that (1) the debtor is generally not paying its debts as they become due, unless such debts are the subject of a bona fide dispute concerning liability or amount; or (2) within 120 days before the date of the filing of the petition, a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession. 11 USC §303(h). Note that for voluntary bankruptcy cases, there is no insolvency, inability to pay debts when due, or other financial standard that must be satisfied in order to commence the case.

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§12.4 C. Operating Under Chapter 11

Following the commencement of a Chapter 11 case, the debtor is generally permitted to operate under the supervision of the bankruptcy court until a plan of reorganization becomes effective following its confirmation by the bankruptcy court, at which time the debtor emerges from Chapter 11 with a discharge of its prebankruptcy debts unless the plan is a liquidating plan of reorganization. 11 USC §1141(d)(1), (3). Confirmation of the plan of reorganization generally concludes the bankruptcy case, and the reorganized debtor thereafter operates free of the bankruptcy court's supervision.

The commencement of a Chapter 11 case creates a bankruptcy "estate" that is comprised of all then-existing interests of the debtor in property. 11 USC §541(a)(1). The estate also includes all proceeds, products, and profits of such property and any interest in property that the estate acquires after commencement of the bankruptcy case (11 USC §541(a)(6)) and that is administered by the debtor-in-possession for the benefit of all creditors and shareholders under the exclusive jurisdiction and supervision of the bankruptcy court. A trustee is not appointed in a Chapter 11 case unless one is requested and the bankruptcy court finds that there is cause for the appointment of a trustee. Appropriate grounds include fraud, dishonesty, incompetence, gross mismanagement, or similar causes. 11 USC §1104(a)(1).

Unless the court orders otherwise, a Chapter 11 debtor may continue to enter into transactions that are in the ordinary course of the debtor's business without court approval. Vendors who provide goods and services to the debtor after commencement of the Chapter 11 case (including goods and services provided under a prebankruptcy contract with the debtor) are generally entitled to be paid in full, in cash, for such goods and services. The claims of such vendors normally will be paid currently in the ordinary course of business, and, if not paid currently, would constitute administrative expenses under Bankr C §503(b) that must be paid in full in order for a plan of reorganization to be confirmable under Bankr C §1129. Payments in respect of prepetition claims are generally permitted to be made only in accordance with a confirmed plan of reorganization, except that the debtor may make payments in accordance with its obligations under executory contracts (and unexpired leases) that have not been rejected under Bankr C §365. In addition, under the "necessity doctrine," debtors may sometimes obtain court approval to pay prebankruptcy salaries and expenses owing to employees and prebankruptcy claims owing to key vendors. But see *In re Kmart Corp.* (7th Cir 2004) 359 F3d 866, cert denied (2004) 543 US 1056 (affirmed reversal of bankruptcy order that had approved postpetition payments of prepetition claims of "critical" vendors on the basis of necessity doctrine); *In re B & W Enters.* (9th Cir 1983) 713 F2d 534, 536 (court refused to invoke necessity of payment doctrine "absent compelling reasons"). All transactions outside the ordinary course of business require approval of the court after notice and an opportunity for interested parties to object. 11 USC §363(c)(2).

In addition to operating under the supervision of the bankruptcy court, a Chapter 11 debtor is subject to oversight by a creditors' committee, comprised of creditors holding the seven largest unsecured claims who are willing to serve, that is appointed to represent the interests of all unsecured creditors. 11 USC §1102. The creditors' committee, which is represented by counsel whose fees are paid out of the bankruptcy estate following approval by the bankruptcy court, usually plays an important role in the progress of a Chapter 11 case by actively monitoring the debtor's operations, providing important input regarding such matters as whether the debtor should liquidate or reorganize its assets and business, and negotiating a plan of reorganization.

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§12.5 D. Automatic Stay

Subject to limited exceptions, the commencement of a bankruptcy case triggers an automatic stay of any pending litigation against the debtor, the commencement of any new litigation against the debtor, any creditor collection action (either judicial or nonjudicial) against the debtor or the debtor's property, enforcement of any judgment against the debtor, and any action to repossess or foreclose on any of the debtor's property. See 11 USC §362(a). The automatic stay is enforced by the bankruptcy court through orders of contempt and fines. See, *e.g., Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725, 731 (creditor ordered to pay debtor $4.75 million when court found that creditor willfully violated automatic stay by unilaterally terminating contract to purchase equipment). Accordingly, with limited exceptions (see 11 USC §362(b)), on the commencement of a bankruptcy case, no claims can be asserted or enforced against the debtor or the debtor's property outside the bankruptcy court without first obtaining relief from the automatic stay from the bankruptcy court.

In considering how the commencement of a bankruptcy case may affect rights under a license agreement, it is important to note that the automatic stay also prevents a nondebtor party to a license agreement (or any other type of executory contract) from terminating the agreement unless relief from the automatic stay has been obtained from the bankruptcy court. See *Carroll v Tri-Growth Centre City, Ltd. (In re Carroll)* (9th Cir 1990) 903 F2d 1266. Although in unusual circumstances a bankruptcy court might be willing to grant relief from stay to permit nondebtor parties to enforce their rights and remedies under a contract with the debtor in accordance with nonbankruptcy law, bankruptcy courts are normally reluctant to grant stay relief if the debtor has not yet determined whether to assume or reject the contract and if there appears to be some prospect that the debtor can cure any existing defaults and assume the contract. See, *e.g., In re Kmart Corp*. (Bankr ND Ill 2003) 290 BR 614.

The automatic stay is a fundamental aspect of bankruptcy law. It is intended to give the debtor a breathing spell while the debtor seeks to reorganize its affairs and to centralize in one forum (*i.e*., the bankruptcy court in which the bankruptcy case is pending) the adjudication of all claims against the debtor. See generally H Rep No. 95-595, 340, 95th Cong, 1st Sess (1977), reprinted in 1978 US Code Cong & Ad News 5983, 6296.

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§12.6 E. Chapter 11 Plan Process

The debtor has a 120-day period during which it has an exclusive right to propose a plan of reorganization and a 180-day period to obtain acceptances to a plan that has been filed before expiration of the exclusivity period. 11 USC §1121(b). This exclusivity period may be extended or reduced by the court, although in no event may the 120-day exclusivity period extend longer than 18 months after commencement of the case or the 180-day period extend longer than 20 months after commencement of the case. 11 USC §1121(d). Once the exclusivity period ends, any party in interest may propose a plan. Courts often extend the exclusivity period, particularly in large cases.

After the debtor develops a business plan for its restructured operations and ordinarily before the debtor's exclusive right to file a plan of reorganization terminates, the debtor normally files a plan of reorganization that, if confirmed, will allow it to emerge from bankruptcy. See generally 11 USC §§1121-1123. The plan operates as a master contract under which the reorganized debtor (or a successor to the debtor if designated in the plan) agrees to a repayment schedule (which may be embodied in the terms of new securities to be issued under the plan) based on the reorganized debtor's (or the debtor's successor's) projected cash flow. In the case of a liquidating plan of reorganization, the cash proceeds from the sale of the debtor's assets are pooled and paid out to creditors in accordance with their legal priorities.

The plan becomes effective only if it is confirmed by the bankruptcy court at a hearing at which all creditors, equity holders, and other parties in interest have an opportunity to object. See 11 USC §1128. Before the confirmation hearing, a disclosure statement containing information about the debtor and the plan must be circulated to all parties whose rights are impaired under the plan. See 11 USC §§1124-1125. Further, for each class of impaired claims, either the holders of more than one-half in number and two-thirds in amount of the claims in that class must have accepted the plan, or else any dissenters in that class must receive or retain a specified value of property under the plan. See 11 USC §§1126(c), 1129(a)(7). On confirmation, the plan is binding on all persons, including dissenting creditors and equity holders. 11 USC §1141(a).

A debtor usually negotiates the principal terms of its plan of reorganization with its creditors' committee and other major constituencies before filing the plan. The goal of a Chapter 11 case is to have a consensual plan of reorganization that creditors and shareholders will not contest. Nevertheless, it is not unusual for one or more constituencies to contest confirmation of a plan in an effort to coerce the debtor (or other plan proponent) to modify the plan to increase the distributions to be made on account of the constituencies' claims or interests.

The plan specifies the treatment to be afforded each class of creditors and equity holders. See 11 USC §1123. In all cases, each secured creditor is entitled to receive the present value (in the form of deferred cash payments or other property) of its collateral (up to the amount of the secured debt) ahead of unsecured creditors. See 11 USC §1129(b)(2)(A). The plan may propose that cash payments or distributions of new debt or equity securities (or both) or other property be made to unsecured creditors, the amount or value of which largely depends on the going concern value of the debtor, the amount of secured debt, and the value of the collateral securing such debt. Equity holders typically receive relatively little value under a plan unless the plan provides unsecured creditors with substantial, if not full, recoveries in respect of their claims.

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F. Assumption and Rejection of Executory Contracts

§12.7 1. Executory Contract: Definition

The provisions of Bankr C §365 are of paramount significance in a bankruptcy filing by a licensor or licensee of intellectual property rights. These provisions allow the debtor, with court approval, to assume or reject executory contracts. Particularly significant is the debtor's power to reject, and thereby avoid the debtor's remaining obligations under, executory contracts that are considered burdensome or unprofitable—which implements the fresh start and rehabilitation policies underlying the Bankruptcy Code.

The term "executory contract" is not defined in the Bankruptcy Code, but is generally considered to refer to a contract on which material performance remains due on both sides. Most courts, including those in the Ninth Circuit, apply the so-called "Countryman" definition (first articulated by Professor Vern Countryman):

> A contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

Countryman, *Executory Contracts in Bankruptcy*, 56 Minn L Rev 439, 446 (1973). See *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702, 705 n7. Another approach adopted by some courts (sometimes referred to as the "functional test") analyzes the question of whether a contract should be treated as an executory contract based solely on a determination of whether the bankruptcy estate would benefit if the contract were treated as an executory contract that is subject to rejection under Bankr C §365. See, *e.g., Martin Bros. Toolmakers, Inc. v Industrial Dev. Bd. (In re Martin Bros. Toolmakers, Inc.)* (11th Cir 1986) 796 F2d 1435.

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§12.8 2. Intellectual Property Licenses as Executory Contracts

Courts generally hold that licenses of intellectual property constitute executory contracts for purposes of Bankr C §365 given the various future performance obligations that a licensor and licensee typically undertake under a license agreement. See, *e.g., Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673, 677; *In re Kmart Corp.* (Bankr ND Ill 2003) 290 BR 614, 618; *In re HQ Global Holdings, Inc.* (Bankr D Del 2003) 290 BR 507, 510. See also Countryman, *Executory Contracts in Bankruptcy*, 56 Minn L Rev 439, 501 (1973) (noting that a patent license ordinarily takes the form of an executory contract). Rare exceptions to this general rule include *In re Learning Publications* (Bankr MD Fla 1988) 94 BR 763, 765 (license agreement was not executory because the licensor's only continuing role was to receive royalty checks), and *Microsoft Corp. v DAK Indus. (In re DAK Indus., Inc.)* (9th Cir 1995) 66 F3d 1091, 1095 (agreement permitting debtor to install specified number of copies of software programs on computers sold by debtor in exchange for fixed payment treated as prepetition sale rather than executory license agreement). For example, the court in *In re Kmart Corp., supra,* in noting that a license agreement is generally treated as an executory contract under §365, observed (290 BR at 618):

> A license agreement can impose any number of on-going performance obligations on the parties, including responsibilities relating to reporting, labeling, policing, service, maintenance and technological upgrades.… The contingency or remoteness of the obligations imposed by a license agreement does not prevent an agreement from being deemed executory in nature.

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§12.9 3. Effect of Rejection

Rejection of an executory contract is essentially a declaration by the debtor that it will not perform its remaining obligations under the contract. On rejection of an executory contract, the debtor no longer can be compelled to perform the debtor's remaining unperformed obligations under the contract, leaving the other party with the sole remedy of a breach of contract damage claim against the bankruptcy estate. See 11 USC §§365(g), 502(g). Ordinarily the breach-of-contract claim will constitute a general unsecured claim as of the date of the filing of the petition, which often is worth only pennies on the dollar. (In unusual cases, the nondebtor party might have obtained a perfected security interest to secure performance of the debtor's contractual obligations, and would therefore have a secured breach-of-contract claim to the extent of the value of the collateral securing the claim.)

Rejection "denies the right of a contracting creditor to require the bankrupt estate to specifically perform the then executory portions of the contract." *Leasing Serv. Corp. v First Tennessee Bank Nat'l Ass'n* (6th Cir 1987) 826 F2d 434, 436. Although the remaining unperformed obligations are discharged through rejection, courts have recognized that rejection "is not the equivalent of rescission." *Murphy v C & W Ltd. (In re Murphy)* (8th Cir 1982) 694 F2d 172. Thus, rejection does not result in the reversal or undoing of already completed transactions such as a conveyance of title. For example, in *In re Executive Technol. Data Sys.* (Bankr ED Mich 1987) 79 BR 276, the debtor had exercised his option to purchase copyrights and license rights prior to bankruptcy. After commencement of the bankruptcy case, the other party moved to compel the debtor to assume or reject the contract (which contained certain executory features), arguing that rejection would require the debtor to transfer back the intellectual property rights that had been purchased. The court held that rejection would not result in the intellectual property reverting back to the seller, because rejection only affects future performance obligations and has no impact on the executed portions of a contract.

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§12.10 4. Partial Rejection Prohibited

An executory contract cannot be rejected in part and assumed in part. See *Sharon Steel Corp. v National Fuel Gas Distrib. Corp.* (3d Cir 1989) 872 F2d 36, 41; *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574, 575. If the debtor-in-possession or trustee assumes an executory contract, the contract must be accepted in its entirety. In some cases, a contract may be found to form part of a series of related agreements that constitute a single integrated transaction, thereby requiring that all of the agreements be either assumed or rejected at the same time. For example, in *In re Exide Technols.* (Bankr Del 2006) 340 BR 222, the bankruptcy court considered whether to authorize rejection of a trademark license agreement that was entered into in connection with a series of agreements between a seller and purchaser of an industrial battery business. The court found that the trademark license agreement, together with an asset purchase agreement, an administrative services agreement, and a letter agreement, represented a single, fully integrated agreement that was required to be treated as a single contract for purposes of assumption or rejection under Bankr C §365. See also *In re Karfakis* (Bankr ED Pa 1993) 162 BR 719, 725 (all of the contracts that comprise an integrated agreement must either be assumed or rejected, because they comprise one contract).

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§12.11 5. Standard for Rejection

The standard for rejection of executory contracts or unexpired leases is whether rejection is an exercise of sound business judgment, a standard that the debtor almost always can readily satisfy. See, *e.g., NLRB v Bildisco & Bildisco* (1984) 465 US 513, 523, 79 L Ed 2d 482, 493, 104 S Ct 1188 (business judgment test is traditional standard to apply in determining whether to approve rejection sought by debtor under Bankr C §365); *Lubrizol Enters. v Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)* (4th Cir 1985) 756 F2d 1043, 1047, cert denied (1986) 475 US 1057 (debtor's decision to assume or reject executory contract under §365 is evaluated under business judgment standard). See also *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276. The unfairness or hardship that the nondebtor party will suffer as a result of rejection rarely is taken into account by the court in determining whether to authorize rejection. Only in the most extraordinary circumstances has the other party to the contract succeeded in persuading a bankruptcy court to deny a motion to reject. A case illustrating the rare exception was *In re Petur U.S.A Instrument Co.* (Bankr WD Wash 1983) 35 BR 561 (rejection denied on grounds that benefit to estate from rejection was vastly disproportionate to harm that licensee would suffer from rejection of patent and trademark license).

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§12.12 6. Timing

In a Chapter 11 case, the debtor may elect to assume or reject an executory contract any time before confirmation of a Chapter 11 plan. 11 USC §365(d)(2). The disposition of an executory contract that is neither rejected nor assumed before plan confirmation is somewhat uncertain, although a number of cases have found that an executory contract that is neither assumed nor rejected "rides through" the case and remains in effect following the debtor's emergence from Chapter 11. See, *e.g., In re Hernandez* (Bankr D Ariz 2002) 287 BR 795 (discussed in §12.75). See also *Stumpf v McGee (In re O'Connor)* (5th Cir 2001) 258 F3d 392, 404. In many cases, plans of reorganization and confirmation orders provide for automatic rejection of any executory contact that has not been expressly assumed before confirmation, thereby minimizing the possibility that a contract could ride through the bankruptcy unaffected. In a Chapter 7 case, any executory contract that is not assumed within 60 days after the entry of an order for relief is automatically deemed to have been rejected, unless an extension is granted. 11 USC §365(d)(1). The nondebtor party to an executory contract can, however, request that the bankruptcy court compel the debtor to determine whether to accept or reject the contract within a specified time period. 11 USC §365(d)(2).

Normally, a Chapter 11 debtor will be afforded at least several months to determine whether to assume or reject and will often be permitted to defer a decision until the time of confirmation of the plan. See, *e.g., Public Serv. Co. of N.H. v New Hampshire Elec. Coop., Inc. (In re Public Serv. Co. of N.H.)* (1st Cir 1989) 884 F2d 11, 14. For example, in *In re Kmart Corp.* (Bankr ND Ill 2003) 290 BR 614, 620, the bankruptcy court denied a motion by a software licensor seeking an order to compel assumption or rejection of a license agreement under which the debtor had failed to keep current in its annual license fee payments. The court observed that courts rarely force a debtor into assuming or rejecting a contract before confirmation and found that the debtor would be harmed if it was forced to decide prematurely whether to assume or reject the license agreement in question.

Before any determination of whether to assume or reject an executory contract, the nondebtor party to the contract remains contractually obligated to perform. *Krafsur v UOP (In re El Paso Refinery, LP)* (Bankr WD Tex 1996) 196 BR 58, 72 ("The [Bankruptcy] Code places an independent duty on the nondebtor to continue the performance of an executory contract until it is assumed or rejected"). Accordingly, if the nondebtor party fails to perform its obligations and the contract is later assumed by the debtor, the nondebtor party will be subject to a breach-of-contract damage claim by the debtor.

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§12.13 7. Assumption

A debtor may assume an executory contract under Bankr C §365 by obtaining court approval of a motion to assume the contract or confirmation of a plan of reorganization that provides for assumption of the contract. On assumption, the bankruptcy estate becomes bound by the executory contract, and all amounts thereafter owed by the debtor under the contract will give rise to administrative expense claims under Bankr C §503(b), which are entitled to be paid in full. If an executory contract is in default at the time the debtor seeks to assume it, assumption will not be permitted unless all monetary defaults are promptly cured, compensation for actual monetary loss resulting from the defaults is paid, and the debtor provides adequate assurance of future performance of the debtor's obligations under the contract. 11 USC §365(b)(1).

Certain types of executory contracts are or may be incapable of assumption by the debtor. For example, Bankr C §365(c)(1) prohibits assumption of an executory contract by the bankruptcy trustee without consent of the nondebtor party if it is a contract with respect to which applicable law excuses the nondebtor party from accepting performance from, or rendering performance to, a third party. It is clear from the statutory language that the prohibition on assumption described in §365(c)(1) applies when a trustee, rather than a debtor-in-possession, is seeking the assumption, but there are conflicting decisions regarding whether §365(c)(1) applies when a debtor-in-possession is the person seeking assumption. See §12.67. This exception has been found to apply to personal services contracts, certain nonassignable governmental contracts, and, as more fully discussed in §§12.65-12.76, certain types of intellectual property licenses.

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§12.14 8. Assignment

A debtor may assign an executory contract following its assumption, provided there is adequate assurance of future performance by the assignee. 11 USC §365(f)(2)(B). Subject to certain exceptions, contractual limitations on the assignment of an executory contract are not enforceable in bankruptcy. 11 USC §365(f)(1). An important exception to this general rule applies to contracts of the kind described in §365(c)(1), *i.e.,* any contract with respect to which applicable nonbankruptcy law excuses the nondebtor party from accepting performance from, or rendering performance to, a third party. See §12.13. These contracts cannot be assigned by the debtor without consent of the nondebtor party, notwithstanding the provisions of §365(f)(1) that generally render any contractual limitations on the assignment of an executory contract unenforceable in a bankruptcy case.

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§12.15 9. General Unenforceability of Ipso Facto Clauses

Bankruptcy Code §365(e) invalidates so-called bankruptcy "ipso facto" default clauses, *i.e.,* clauses that trigger a default or other modification on the insolvency or bankruptcy of the debtor. To the extent such clauses include insolvency or other financial condition tests that may be applicable outside of a bankruptcy proceeding, the clauses are generally enforceable if exercised before commencement of a bankruptcy case. Once a bankruptcy case is commenced, however, ipso facto clauses will not be enforceable, except for clauses included in contracts of the kind described in §365(e)(2)(A) (the same types of contracts that are subject to Bankr C §365(c)(1), including most types of intellectual property licenses; see §12.13) or §365(e)(2)(B) (loan agreements and other types of financing agreements, including an agreement to issue a security of the debtor).

It is customary for all types of executory contracts to include termination or default clauses based on a party's bankruptcy, notwithstanding their unenforceability. Under §365(e), the rights of a debtor under an executory contract containing such a clause cannot be terminated or in any way modified on the basis of such a clause during the debtor's bankruptcy. Thus, subject to the exceptions set forth in §365(e)(2) (referred to in the preceding paragraph), a clause in a license agreement that modifies the scope of the license granted to the licensee (*e.g.,* a clause that converts an exclusive license to a nonexclusive license), triggers the grant of a license, or modifies the license fee or other payment obligations of the licensee on the licensee's filing of a bankruptcy case would be unenforceable once the licensee becomes a debtor in a bankruptcy case. This result assumes that the license agreement is treated as an executory contract under §365, which usually is a safe assumption. (If the license agreement is not executory, nothing in §365 would affect the enforceability of any ipso facto clause or other provision of the agreement.)

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§12.16 10. Exception Relevant to Intellectual Property Licenses

The rule of unenforceability of bankruptcy ipso facto clauses has an exception with important ramifications for intellectual property licenses. Bankruptcy Code §365(e)(2)(A)(i) provides that the prohibition on ipso facto clauses in §365(e)(1) does not apply to an executory contract with respect to which applicable law excuses the nondebtor party from accepting performance from or rendering performance to a third party. This exception is the same one that applies under §365(c) to exclude certain types of executory contracts from assignment and, possibly, assumption under §365. Thus, if a license agreement cannot be assumed or assigned by a debtor licensee under §365(c)(1) because applicable law excuses the nondebtor party from accepting performance from or rendering performance to the debtor, an ipso facto termination clause in that agreement should be enforceable by the nondebtor party in accordance with §365(e)(2)(A)—subject to Bankr C §362, which may automatically stay enforcement of the clause until relief from the automatic stay is obtained. See *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238. For further discussion of this exception, see §12.62.

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§12.17 III. INTELLECTUAL PROPERTY LICENSES IN BANKRUPTCY

The treatment of intellectual property license agreements in bankruptcy cases is discussed in the following sections of this chapter. The effect of a bankruptcy filing on a license agreement is very different depending on whether the licensor or the licensee is the debtor. The issues that arise when the licensor is the debtor and the licensor rejects the license agreement under Bankr C §365 are discussed in §§12.18-12.51, with particular focus on the protections afforded to a licensee under Bankr C §365(n) following the debtor-licensor's rejection of the agreement. Drafting and structuring suggestions intended to address the risks and problems associated with a licensor bankruptcy are discussed in §§12.52-12.57.

The issues that arise in a bankruptcy filing by a licensee are considered in §§12.58-12.78. In general, these issues are more straightforward than those that arise in the context of a licensor bankruptcy filing, except for the issue discussed in §§12.65-12.76 of the extent to which intellectual property licenses are not capable of being assumed or assigned by a debtor-licensee under Bankr C §365(c).

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A. Bankruptcy Filing by Licensor

§12.18 1. Legislative History of §365(n)

Before enactment of Bankr C §365(n) in 1988, a number of cases—including, most notably, *Lubrizol Enters. v Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)* (4th Cir 1985) 756 F2d 1043, cert denied (1986) 475 US 1057—held that a debtor-licensor's rejection of an intellectual property license under Bankr C §365 resulted in termination of the license. In *Lubrizol,* the Fourth Circuit held that rejection of a license agreement terminated the nondebtor party's right to use the metal coating technology licensed under the agreement. Responding to *Lubrizol* and other cases that interpreted §365 as permitting a debtor-licensor to terminate the licensee's rights on rejection, Congress enacted the Intellectual Property Bankruptcy Act of 1988 (Pub L 100-506, 102 Stat 2538), which adopted Bankr C §365(n). Section 365(n) permits a licensee of certain intellectual property rights to elect to retain its rights under a rejected license agreement as those rights existed on the date of bankruptcy, subject to the licensee continuing to pay royalties due under the license agreement without exercising any setoff rights with respect to the agreement.

NOTE: The Ninth Circuit has noted that §365(n) balances the relevant competing interests so that "(t)he bankrupt cannot terminate and strip the licensee of rights the licensee had bargained for" and likewise "(t)he licensee cannot retain the use of those rights without paying for them." *Encino Bus. Mgmt., Inc. v Prize Frize, Inc. (In re Prize Frize, Inc.)* (9th Cir 1994) 32 F3d 426, 428.

The rationale of *Lubrizol* continues to apply to the extent that a licensee does not make the election under §365(n) or the license involves intellectual property rights not protected by §365(n) (principally, trademarks or tradenames; see §12.29)—at least in jurisdictions in which courts held that rejection of a license agreement divested the licensee of its licensed rights. It should be noted that some courts did not follow the rule adopted in *Lubrizol*. See, *e.g., Fenix Cattle Company v Silver (In re Select-A-Seat Corp.)* (9th Cir 1980) 625 F2d 290, 293 (observing that trustee's rejection of software license affected executory warranty and exclusive dealing obligations of debtor-licensor, but did not affect licensee's rights to continue to use and sell licensed computer software, and stating that license "cannot be summarily terminated, but rejection can cancel covenants requiring future performances by the debtor"). Many cases and commentaries assume without discussion that, if §365(n) is inapplicable, the *Lubrizol* rule necessarily applies to terminate the licensee's right to licensed intellectual property. This assumption may be dubious, given that the legislative history of the Intellectual Property Bankruptcy Act of 1988 unequivocally states that the cases adopting the *Lubrizol* rule did not reflect the legislative intent underlying §365 and the *Lubrizol* rule was not uniformly applied by courts addressing the effect of rejection of a license agreement. In any case, it is not obvious that the discharge of the debtor's remaining affirmative performance obligations that occurs on rejection necessarily should mean that intangible rights previously granted by the debtor under the agreement that do not require any affirmative performance by the debtor to be enjoyed by the licensee necessarily should fall away upon rejection.

The Senate Report accompanying the bill that became the Intellectual Property Bankruptcy Act of 1988 (Pub L 100-506, 102 Stat 2538) states that the purpose of the bill was to protect intellectual property licensees in the wake of judicial decisions that had cut off those rights in the licensor's bankruptcy. S Rep 100-505, 100th Cong, 2d Sess (1988), reprinted in 1988 US Code Cong & Ad News (USCCAN) 3200. The report describes the important problem that §365(n) was intended to address as follows (S Rep No. 100-505 at 3, 1988 USCCAN at 3201):

> [Cutting off the licensee's rights on rejection of a license agreement] leaves licensees in a precarious position and thus threaten[s] the very flexible and beneficial system of intellectual property licensing which has developed in the United States. Congress never anticipated that the presence of executory obligations in an intellectual property license would subject the licensee to the risk that, upon bankruptcy of the licensor, the licensee would lose not only any future affirmative performance required of the licensor under the license, but also any right of the licensee to continue to use the intellectual property as originally agreed in the license agreement.
>
> The court decisions on [§]365 that have stripped intellectual property licensees of their right to continue to use the licensed property have gained wide notice. They threaten an end to the system of licensing of

> intellectual property… that has evolved over many years to the mutual benefit of both the licensor and the licensee and to the country's indirect benefits.

The legislative history states that §365(n) is intended to parallel the treatment of real estate leases under Bankr C §365(h), which allows a lessee under a rejected lease of real property to elect to retain possession of the leased premises for the remaining term of the lease. S Rep 100-505 at 4, 1988 USCCAN at 3203.

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§12.19 2. General Scope of §365(n)

Bankruptcy Code §365(n) provides special protections for a licensee of intellectual property under a license that is rejected by the debtor-licensor under §365. Section 365(n) provides that, if a debtor in possession (or trustee) rejects an "executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect" to treat the agreement as terminated. The licensee may elect the termination alternative "if such rejection… amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity." 11 USC §365(n)(1)(A). Alternatively, the licensee may (11 USC §365(n)(1)(B))

> retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced.

Thus, the rights protected by §365(n) clearly include any exclusive rights granted by the licensor, rights with respect to embodiments of the licensed intellectual property (see §12.24), and rights under "supplemental" agreements (see §12.26), which the legislative history indicates would include a technology escrow agreement. S Rep No. 100-505, 100th Cong, 2d Sess 9 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3206. If the licensee elects to retain the licensed rights, the election applies for "(i) the duration of such contract; and (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law." 11 USC §365(n)(1)(B). The licensee's election to retain license rights under §365(n)(1)(B) is referred to in this chapter as the "retention election" by the licensee.

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§12.20 a. Covenants Not to Sue

One preliminary question raised by Bankr C §365(n) is what constitutes a "license" of intellectual property. If a license for this purpose includes only a formal, affirmative grant of rights under copyrights, patents, or trade secrets, then a covenant given by a debtor not to bring an infringement suit (commonly referred to as a "covenant not to sue") would seemingly not qualify as a license for purposes of §365(n). A nonexclusive patent license is, however, nothing more than a covenant not to sue the licensee for infringement of the licensed patent. *Murray v Franke-Misal Technols. Group, LLC (In re Supernatural Foods, LLC)* (Bankr MD La 2001) 268 BR 759, 802.

It is difficult to articulate a policy reason why a nonexclusive patent license should be protected by §365(n) but a covenant not to sue for infringement of a patent should not. The principal difference between a nonexclusive patent license and a covenant not to sue for patent infringement is that the covenant not to sue is personal to the covenantee and does not burden the patent, thus permitting a transferee of the patent to acquire ownership of the patent free of any obligation to honor the covenant (unless otherwise agreed by the transferee). In contrast, a transferee of a patent would take the patent subject to any nonexclusive licenses previously granted under the patent. In addition, a purchaser of a product made under a license from the patent owner would be protected from an infringement suit by the patent owner by reason of the exhaustion doctrine under patent law, which precludes a patent owner from asserting an infringement claim against a downstream purchaser of a product made under the authority of the patent owner. A downstream purchaser of a product made by a beneficiary of a covenant not to sue, on the other hand, may not be protected by the exhaustion doctrine and could be subject to an infringement claim by the patent owner (unless the covenant also applied to that purchaser).

There are apparently no published cases addressing whether a covenant not to sue for infringement of specific intellectual property rights should be protected under §365(n) to the same extent as an affirmative license grant. A persuasive argument can be made, however, that a covenant not to sue under a patent should be treated as a license for purposes of §365(n) and therefore should be protected to the same extent as an affirmative patent license.

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§12.21 b. Postpetition Improvements to Licensed Intellectual Property

It is important to note that the retention election under Bankr C §365(n)(1)(B) seemingly applies only to license rights as they existed immediately before commencement of the bankruptcy case. Thus, the licensee's election to retain its intellectual property rights preserves the licensee's prebankruptcy rights with respect to the licensed intellectual property for the duration of the rejected license agreement, plus any applicable extension of the term of the agreement. The retention election does not, however, appear to provide any right to obtain improvements or other developments made by the debtor-licensor after the filing of the bankruptcy petition, such as, in the case of a software license, any upgrades or new versions of the licensed software developed after commencement of the bankruptcy case.

Some commentators have suggested that the limitation to the rights as they existed immediately before commencement the bankruptcy case was not intended to limit a licensee's rights to intellectual property developed after the filing of the bankruptcy petition. In their view, the limitation was only meant to require that the license rights in question vested before the bankruptcy, without regard to the status of the intellectual property to which those rights relate. See Epstein & Politano, Drafting License Agreements ¶6.02[C][2] (4th ed 2002). As discussed more fully in §§12.33-12.35, this view seems inconsistent with the legislative history and has not been followed in any reported court decisions. Given the dearth of applicable case law and the policies underlying §365(n), however, a court might be persuaded to adopt this position.

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§12.22 c. No Right to Specific Performance

The right to retain the licensed rights generally does not enable the licensee to enforce affirmative performance obligations of the licensor, such as any obligation to provide technical support, to defend third party infringement claims, to enforce or assist in the enforcement of exclusively licensed rights against third party infringers, or to maintain licensed patents in force. The Senate report states as follows in this regard (S Rep 100-505, 100th Cong, 2d Sess 9 (1988), reprinted in 1988 US Code Cong & Ad News (USCCAN) 3200, 3206):

> If the trustee has chosen to reject the license, the licensee, although entitled to elect to retain the use of the existing intellectual property without interference, cannot otherwise compel affirmative post-petition performance under the license. For instance, the licensee could not compel the licensor to defend the licensor's patent against an infringement claim. If the license provided the licensee a right to defend such a claim, however, that is one of the rights which this bill would protect.

Although a licensee making the election generally cannot compel specific performance of any continuing affirmative obligations by the debtor-licensor, the licensee can require the debtor (1) to deliver possession of embodiments of the licensed intellectual property to the extent provided in the license agreement (see §12.24) and (2) to honor any exclusive rights granted to the licensee with respect to the licensed intellectual property.

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§12.23 d. Right to Obtain Licensed Intellectual Property on Written Request

Before rejection of a license agreement, or after the licensee makes the retention election following rejection of a license agreement, the debtor-licensor is prohibited from interfering with the licensee's rights to use the licensed intellectual property and is obligated to provide the licensee with any intellectual property (including any embodiment thereof) held by the debtor-licensor to the extent provided in the license agreement. 11 USC §365(n)(3)-(4). The debtor's obligation to provide the licensee with such intellectual property arises on the licensee's written request.

It is not clear whether a written request made by a licensee under §365(n)(3) or (4) would violate the automatic stay under Bankr C §362 if made without first obtaining relief from the automatic stay from the bankruptcy court. Nothing in the legislative history of §365(n) suggests that Congress intended to require a licensee to first seek relief from stay before exercising any of the rights affirmatively granted by §365(n)(3)-(4), and apparently no cases have so held. It would seem incongruous with the intent underlying §365(n) to require a licensee to seek bankruptcy court approval before exercising an unqualified right expressly provided for in the Bankruptcy Code. Nevertheless, given the breadth of the automatic stay, a licensee making a request for delivery of embodiments of intellectual property under §365(n)(3) or (4) should consider whether, as a precautionary matter, relief from the automatic stay should be sought before making such a request.

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§12.24 e. Rights to Embodiments of Intellectual Property

The rights protected by Bankr C §365(n) include the right to obtain possession of embodiments of licensed intellectual property. The Senate report notes that examples of such embodiments include a prototype incorporating the licensed intellectual property, "genetic material needed to produce certain biotechnological products and computer program source codes" and observes that "critical to any right of the licensee to obtain such embodiments… is the prepetition agreement of the parties that the licensee have access to such material and the physical existence of such material on the day of the bankruptcy filing." S Rep 100-505, 100th Cong, 2d Sess 10 (1988), reprinted in 1988 US Code Cong & Ad News (USCCAN) 3200, 3207.

NOTE: Nothing in the legislative history of §365(n) suggests that the licensee has any right to obtain any embodiments of intellectual property that first come into existence after commencement of the bankruptcy case.

Accordingly, §365(n) is intended "to cover both the intangible legal right associated with intellectual property and the tangible object or objects, such as books, blueprints and electronic media, in which such intellectual property may be fixed or recorded." S Rep No. 100-505 at 7, 1988 USCCAN at 3205. The views of the General Counsel of the Department of Commerce regarding the enactment of §365(n), which are included in the Senate report, reflect the suggestion that it would be "useful for the term 'embodiment' to be interpreted broadly enough to include access to tangible materials required under the license and without which the licensee would be prevented from exercising the license." S Rep No. 100-505 at 12, 1988 USCCAN at 3210.

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§12.25 f. Conditions to Retention Election

Bankruptcy Code §365(n)(2) imposes specific conditions on a licensee's right to make a retention election following rejection of a license agreement by the debtor-licensor. First, the licensee must make all royalty payments due under the remaining term of the license. 11 USC §365(n)(2)(B). This payment obligation includes all amounts payable in consideration of the grant of the license, such as license fees, whether or not the payments would normally be characterized as a royalty payment. *Encino Bus. Mgmt., Inc. v Prize Frize, Inc. (In re Prize Frize, Inc.)* (9th Cir 1994) 32 F3d 426. Other payments owing under a license agreement, such as technical support or services fees, are not required to be paid in connection with making the retention election. A licensee thus has an opportunity to engage in some prebankruptcy planning by unbundling a license fee or royalty into a license fee (which would be required to be paid if the retention election is made) and a support fee (which would not be required to be paid if the retention election is made).

Some commentators have suggested that the continuing royalty obligation in Bankr C §365(n)(2)(B) should be read to require a licensee that makes a retention election to continue to be obligated to provide any nonmonetary consideration due under a rejected license agreement. These commentators have also suggested that, when the nondebtor party makes the retention election following rejection of a patent cross-license agreement, the nondebtor party arguably should continue to be obligated to extend the reciprocal patent license to the debtor-licensor, rather than being permitted to terminate it as a result of rejection. Levinson, Morse, Uhland, Barron & DeBré, *Was Professor Ward Really Serious? IP and Bankruptcy—When Worlds Collide*, Financial Lawyers Conference, Los Angeles, California, Feb. 2, 2006 (unpublished seminar materials).

NOTE: Although the court in the *Prize Frize* case confirmed that all payments owing for use of the licensed intellectual property are required to be made under §365(n)(2)(B), neither the Prize Frize decision nor other published decisions indicate that the royalty requirement should be construed to extend to nonmonetary consideration.

Second, under Bankr C §365(n)(2)(C)(i), the licensee making a retention election is deemed to waive any right of setoff it may have with respect to the breach-of-contract claims arising from rejection of the license agreement.

NOTE: Some commentators have suggested that, following a retention election, a licensee may still be permitted to exercise rights of recoupment, which refers to offsetting claims or obligations arising under the same contract. See, e.g., Cieri & Morgan, *Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee's Intellectual Property and Technology Investment*, 55 Bus Law 1649, 1678 (2000). It seems unlikely that the language prohibiting the setoff of claims arising under the same contract could somehow be construed to permit the exercise of recoupment, which in this context effectively is the same thing.

Finally, under Bankr C §365(n)(2)(C)(ii), a licensee making the retention election is deemed to waive any claim for an administrative expense (which would be entitled to payment in full in the bankruptcy case under Bankr C §503(b)) in connection with the performance of the contract.

NOTE: As a general matter, the nondebtor party to a rejected executory contract is entitled to assert an administrative expense claim with respect to any benefit conferred on the bankruptcy estate as a result of postpetition performance under an executory contract. Whether or not the election is made, the licensee in any case will have a general unsecured claim for damages arising from the debtor's rejection. 11 USC §365(g). See §12.9.

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§12.26 g. Rights Under Supplemental Agreements

Bankruptcy Code §365(n) specifically protects rights under agreements that are "supplemental" to a rejected agreement in which an intellectual property license is granted. The Senate report notes that it is not unusual for a license agreement "to be one of several agreements governing the working relationship between the licensor and licensee," for example, when the licensor has contracted "to supply the licensee with a product incorporating the licensed intellectual property." S Rep No. 100-505, 100th Cong, 2d Sess 9 (1988), reprinted in 1988 US Code Cong & Ad News (USCCAN) 3200, 3206. Thus, the licensee would retain rights in the rejected license and in any supplementary agreement, whether or not the latter were rejected. The Senate report discusses the underlying intent of these provisions as follows (S Rep No. 100-505 at 9, 1988 USCCAN at 3206):

> To assure the licensee of access to such secret information at the defined time, the licensor may have agreed to turn over such information to a third party to be held in escrow until the triggering event. The third-party escrow agent would be a party to such an agreement, and the agreement would be set forth in a document separate from the basic license. Section 365(n)(1)(B), thus, speaks of the retention by the licensee of rights to the intellectual property under "any agreement supplementary to such contract." The licensee retains both the rights set forth in the rejected license itself and any agreement supplementary thereto, whether the supplementary agreement was itself the subject of a rejection by the trustee. This bill is intended to restore confidence in the system of intellectual property licensing, and courts interpreting it should be sensitive to the reasonable practices that have and will evolve among parties seeking to add to the technological and creative wealth of America.

These provisions are plainly intended to facilitate the use and enforcement of source code and other technology escrow arrangements.

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§12.27 3. Licensed Intellectual Property Protected by §365(n)

The most significant issue raised by Bankr C §365(n) is what intellectual property is protected by §365(n). This question has two aspects: (1) the scope of the definition of "intellectual property" in Bankr C §101(35A), as discussed in §§12.28-12.31, and (2) the determination of what rights are deemed to be in existence immediately before commencement of a bankruptcy case within the meaning of §365(n)(1)(B), as discussed in §§12.32-12.37.

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§12.28 a. Types of Intellectual Property Protected

The initial inquiry in this regard is what types of intellectual property rights constitute "intellectual property" for purposes of Bankr C §365(n). The term "intellectual property" is defined as a (Bankr C §101(35A)):

- Trade secret;
- Invention, process, design, or plant protected under Title 35;
- Patent application;
- Plant variety;
- Work of authorship protected under Title 17; or
- Mask work protected under chapter 9 of Title 17, to the extent protected by applicable nonbankruptcy law.

Senate Rep No. 100-505, 100th Cong, 2d Sess 7 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3204, indicates that this definition is intended "to include virtually all types of such rights (other than trademarks and similar rights) whether protected by federal or State law, statutory or common law."

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b. Excluded Intellectual Property

§12.29 (1) Trademarks

Congress did not include trademarks within the definition of "intellectual property" because trademarks were thought to raise special concerns requiring further consideration, given the affirmative obligation of a trademark owner to monitor a licensee's use of licensed trademarks and enforce quality control standards in connection therewith. The legislative history of Bankr C §365(n) indicates that Congress intended bankruptcy courts to consider application of the principles of §365(n) to trademark licenses on an equitable basis. Senate Rep No. 100-505, 100th Cong, 2d Sess 6 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3204, states that "since these matters [relating to trademark licensing] could not be addressed without more study, it was determined to postpone Congressional action in this area and to allow the development of equitable treatment of the situation by bankruptcy courts."

Bankruptcy courts generally have not taken up Congress's invitation to apply equitable principles in connection with determining the consequences of rejection of trademark licenses. There appear to be no published cases in which a court has applied the principles embodied in §365(n) to a pure trademark license as an equitable matter, although the court in *In re Ron Matusalem* (Bankr SD Fla 1993) 158 BR 514 suggested in dicta that the court could, as an equitable matter, apply the provisions of §365(n) to a trademark license. Other courts have held, with little discussion of the issue, that the rights under a trademark license are extinguished on rejection, with no protection afforded by §365(n). See, *e.g., In re HQ Global Holdings, Inc.* (Bankr D Del 2003) 290 BR 507; *In re Old Carco LLC* (Bankr SD NY 2009) 406 BR 180. The court in *Raima UK Ltd v Centura Software Corp. (In re Centura Software Corp.)* (ND Cal 2002) 281 BR 660, however, did suggest that there might be some prospect for a trademark licensee to retain its rights as an equitable matter under §365(g) if the licensee took action early in the case to seek protection of its trademark rights.

The plight of a trademark licensee whose licensor becomes a debtor is illustrated by the recent case *In re Exide Technols.* (Bankr Del 2006) 340 BR 222. In *Exide Technols.,* a debtor licensor was permitted to reject an exclusive, perpetual, fully paid license to use the name "Exide" in connection with the industrial battery business that was sold to the licensee by the licensor more than 10 years before commencement of the bankruptcy case. After the noncompete covenant to which the debtor had agreed expired, the debtor decided to go back into the industrial battery business and concluded that it should try to reacquire the right to use "Exide" in that business. The licensee alleged that it would suffer damages of in excess of $67 million if rejection were to be approved and the trademark license were to be terminated. The court questioned the licensee's ability to prove damages of such an amount, but found that, even if the licensee could prove such damages, the bankruptcy court would not deny rejection. The court, noting that that §365(n) is inapplicable to a trademark license, ruled that rejection terminated the license agreement, leaving the licensee with the sole remedy of asserting a general unsecured claim against the estate. The court did not acknowledge Congress's indication in the legislative history that courts should determine the consequences of rejection as an equitable manner on a case-by-case basis or that the ruling in *Lubrizol Enters. v Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)* (4th Cir 1985) 756 F2d 1043, cert denied (1986) 475 US 1057 (see §12.18) did not reflect the congressional intent underlying §365. Moreover, the court did not indicate any recognition of the fact that, before enactment of §365(n), the *Lubrizol* holding that rejection of a license agreement results in stripping away a licensee's license rights under the rejected license agreement was not universally followed.

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§12.30 (2) Domain Names; Databases; Rights of Publicity

In addition to trademarks or similar rights such as trade names or trade dress rights, the rights of a registered user of a domain name are excluded from the definition of "intellectual property" in Bankr C §101(35A) (see §12.28). Therefore, a registered user's rights would not be protected under §365(n) in the event a domain name registry were to become a debtor in a bankruptcy case and to reject the registered user agreement under which the domain name rights were granted. In addition, statutory rights that protect databases and data collections under the law of certain European jurisdictions (which rights are in addition to any copyrights associated with the manner of selection and arrangement of data) are not included in the definition of "intellectual property" in Bankr C §101(35A) and are therefore not protected by §365(n) (attempts have been made at various times to create federal intellectual property protections for certain types of data, but these efforts so far have failed). Similarly, rights of publicity, which may be very important in the context of an entertainment industry transaction or other transaction where the image or persona of an individual is used for marketing purposes, are not covered by the definition of "intellectual property" in Bankr C §101(35A).

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§12.31 (3) Foreign Patents and Copyrights

The definition of "intellectual property" in Bankr C §101(35A) clearly includes patent rights and copyrights protected under United States law, but its application to foreign patents and copyrights is uncertain. At first blush, it appears that licenses of patents or copyrights issued or arising under the law of a foreign country are not covered by the definition of "intellectual property" in §101(35A), and therefore that licenses under foreign patents and copyrights are not protected under Bankr C §365(n). Section 101(35A) defines "intellectual property" to include an "invention, process, design, or plant that is protected under title 35" of the United States Code (35 USC §§101-376) and a "work of authorship protected under title 17" of the United States Code (17 USC §§101-1332). There is no policy reason, however, why a license under a United States patent or copyright should be protected but a license under a foreign patent or copyright should not be protected. Nothing in the legislative history of §365(n) suggests that Congress thought licenses of foreign patents and copyrights were deserving of less protection than licenses of United States patents and copyrights.

NOTE: The definition of "intellectual property" in §101(35A) refers to an "invention, process, design, or plant" that is protected under the Patent Act, rather than to the United States patent itself or the exclusive rights conferred thereby. If an invention is covered by a United States patent, it could be argued, consistent with the technical language of §101(35A), that all intellectual property rights associated with it are included in the definition, irrespective of the law under which such rights arise, given that it is the invention and not the patent itself that is included in the definition. Of course, this interpretation would not be helpful to a licensee seeking to protect a license of a foreign patent if no corresponding United States patent had been obtained. Moreover, "patent application" is included in the definition of "intellectual property" irrespective of the jurisdiction in which it is filed—there is no logic to including a patent application wherever filed, but in the case of issued patents including only United States patents.

In the case of copyrights, the definition of "intellectual property" in §101(35A) includes a "work of authorship" that is protected under Title 17 of the United States Code, but not the copyright rights themselves. Thus, if a work of authorship is protected under Title 17, it will be entitled to protection under the laws of foreign countries by virtue of international copyright conventions and treaties. It would therefore appear that, on its face, §101(35A) covers foreign copyright rights that apply to works protected under Title 17 and international copyright conventions and treaties. The only literal gap in coverage would appear to be for foreign copyrights in works that were first published in a foreign nation that is not a party to an international copyright convention or treaty and that do not otherwise qualify for protection under Title 17 under any of the conditions set forth in 17 USC §104 that extend copyright protection to foreign works.

Finally, it should be noted that the phrase "to the extent protected by applicable nonbankruptcy law" that appears at the end of the definition of "intellectual property" in §101(35A) applies to each of the types of intellectual property enumerated in subparagraphs (A) through (F) of the definition. Nothing in the phrase "applicable nonbankruptcy law" suggests any intent to limit any of the enumerated types of intellectual property to rights arising only under United States law, and if Congress, for some inexplicable reason, intended to protect only intellectual property rights arising under United States law, the language at the end of the definition of "intellectual property" in §101(35A) readily could have been clarified to refer to applicable state or federal law.

Based on the foregoing, it can be persuasively argued that licenses under foreign patents and foreign copyrights should be protected by Bankr C §365(n) to the same extent as licenses under United States patents and copyrights are protected. Some commentators, however, reading §101(35A) literally, conclude otherwise. See, *e.g.,* Epstein & Politano, Drafting License Agreements ¶6.02[C][1] n42 (4th ed 2002), which states that the consensus among commentators appears to be that foreign patents are excluded from the definition of "intellectual property" under §101(35A). In any case, given the literal language of §101(35A), however, the outcome of this issue is uncertain and a court addressing this issue as a matter of first impression could reach a contrary conclusion. For the reasons set forth above, however, courts should have little difficulty finding that rights based on foreign copyright law protection available through

international treaties or conventions (*e.g.,* the Berne Convention; see §11.43) that inure in a work of authorship protected under U.S. copyright law are subsumed within the definition of "intellectual property" in §101(35A).

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§12.32 c. Effect of Temporal Limitation

The second important limitation affecting the scope of licensed rights protected by Bankr C §365(n) is the limitation that only rights that existed immediately before the commencement of the bankruptcy case by the licensor are protected. Read literally, this language appears to refer to the rights granted by the licensor and not the underlying intellectual property to which the granted rights relate. In what appears to be the only case addressing this issue, a federal district court, consistent with the legislative history, read this limitation as applying to the intellectual property (and related embodiments) that existed immediately prior to bankruptcy and not to the status and scope of the licensed rights themselves. The court found that the debtor, by retaining its rights under §365(n), "became 'entitled to [continue to] use the underlying intellectual property [but only] in the state that it existed on the day of the bankruptcy filing.' " *Szombathy v Controlled Shredders, Inc.* (ND Ill 1997) 1997 US Dist Lexis 5168, *3 (quoting S Rep No. 100-505, 100th Cong, 2nd Sess 9 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3206). Accordingly, it appears that what Congress actually meant by the words "rights… to intellectual property.… as such rights existed immediately before the case commenced" is the following: rights to intellectual property in the state that such intellectual property existed immediately before the commencement of the bankruptcy case.

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(1) Postpetition Improvements or Developments

§12.33 (a) Case Law and Commentary

Some commentators, reading the language of Bankr C §365(n) literally, believe that §365(n) preserves a licensee's entitlement to any improvements or other developments that are created after the bankruptcy filing, notwithstanding the inability of the licensee to compel the debtor-licensor to create such postpetition improvements or new developments following rejection. See Epstein & Politano, Drafting License Agreements ¶6.02[C][2] (4th ed 2002); Halpern, *Bankruptcy Issues in Intellectual Property Licenses*, Practising Law Institute, Intellectual Property Series, No. 411 (2005). Of course, this view assumes that, as is often the case with commercial software licenses, the license in the rejected agreement extends to such improvements and developments. Although it is understood that the licensee under a rejected license agreement cannot compel the licensor to create such improvements or developments (see §12.22), these commentators conclude that, once such improvements or developments have been created and are available, the license to such improvements and developments is protected through the retention election to the same extent as the licensed intellectual property (and its embodiments) that was in existence prior to bankruptcy. For example, one commentator has stated as follows in this regard (Drafting License Agreements ¶6.02[C][2]):

> The licensee will have rights to improvements or other further developments to the intellectual property if its rights to them exist at the commencement of the case even if the improvements or developments themselves are not made until after commencement of the case. Even though the licensee has no right to specific performance of any obligation of debtor-licensor to continue development activities, to the extent debtor-licensor nevertheless makes post-bankruptcy developments, licensee would retain whatever rights to them the license agreement provided to licensee as of commencement of the case. It is not important when the developments occur. Rather it is the contract language describing the licensee's rights in the developments that [is] important.

No cases have been found that adopt this reading of Bankr C §365(n)(1)(B). *Szombathy v Controlled Shredders, Inc.* (ND Ill 1997) 1997 US Dist Lexis 5168 appears to be the only case in which a court has addressed this issue and reached the opposite conclusion, holding that intellectual property created postpetition is not included in the licensed intellectual property preserved by a retention election made by a licensee after rejection of the license agreement.

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§12.34 (b) Legislative History

The legislative history suggests that Congress intended that a licensee's rights to postpetition developments would be cut off by the licensor's rejection, notwithstanding a retention election by the licensee. For example, the Senate report states that Bankr C §365(n) "protects the licensee's right to the intellectual property as it existed at the time of bankruptcy" (S Rep No. 100-505, 100th Cong, 2nd Sess 8 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3205). The Senate report also states that the bill enacting §365(n) reflects a limitation that the licensee's retained rights "are only in the underlying intellectual property as it existed at the time of the filing." S Rep No. 100-505 at 8, 1988 USCCAN at 3206. The Senate report further states that if a license agreement has been rejected, the representative of the bankruptcy estate is "entitled to elect to retain the use of the existing intellectual property without interference." S Rep No. 100-505 at 9, 1988 USCCAN at 3206. In referring to the licensee's right to embodiments of licensed intellectual property under §365(n)(1)(B), the Senate report observes that the physical existence of such embodiments on the day of the bankruptcy filing is critical to a licensee's right to such embodiments. S Rep No. 100-505 at 10, 1988 USCCAN at 3207. Finally, in discussing the licensor's obligation under §365(n)(3) and (4) to provide intellectual property to the licensee and not to interfere with the licensee's rights to obtain licensed intellectual property (or embodiments thereof), the Senate report states that the "intellectual property referred to is only that which is in existence at the time of petition filing and not anything which first comes into being post-petition." S Rep No. 100-505 at 10, 1988 USCCAN at 3208.

No suggestion is made anywhere in the legislative history that the retained rights of a licensee following rejection of a license agreement under any circumstances could extend to intellectual property created after the commencement of the bankruptcy case. Accordingly, although the issue is not free from doubt, it appears unlikely that a court would find that a licensee who makes a retention election can ever extend its retained license rights under §365(n) to any intellectual property developed after commencement of the licensor's bankruptcy case.

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§12.35 (c) Policy Considerations

The policy underlying Bankr C §365(n)—of protecting a licensee's vested license rights, while at the same time relieving the debtor-licensor of any postpetition obligation to perform affirmative obligations such as support services—supports interpreting §365(n)(1)(B) to extend the licensee's retained rights under a retention election to any improvements or other developments within the scope of the license grant that the debtor-licensor develops after commencement of the case (even if it had no enforceable legal obligation to do so). For a discussion of the competing policy concerns underlying this question of statutory interpretation, see Canavan, *Unsolved Mysteries of Section 365(n)—When a Bankrupt Technology Licensor Rejects an Agreement Granting Rights to Future Improvements*, 21 Seton Hall L Rev 800 (1991).

In the context of a rejection of an exclusive license that covers all improvements or other derivative works based on the licensed intellectual property, the preservation of the licensee's exclusive rights under §365(n), coupled with the loss of all rights to improvements or other such derivative works created by the licensor after commencement of the bankruptcy case, leads to a curious result: Neither the licensor nor the licensee would be legally permitted to exercise any of the exclusive rights granted to the licensee with respect to such postpetition improvements or other such derivative works. Because a licensee's exclusive rights are fully preserved by a retention election, there would be no basis in the context of a rejection of the license agreement for the licensor to be permitted to commercially exploit postpetition improvements of the exclusively licensed intellectual property made by the licensor, even though the licensee's retained license rights do not extend to such improvements. See Canavan, *Unsolved Mysteries of Section 365(n)*, p 822 n79. Presumably, the licensor and licensee in such a situation would be motivated to negotiate a mutually acceptable resolution of such a stalemate.

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§12.36 (2) Patents Issued Postpetition

Consistent with the legislative history of Bankr C §365(n), if the rights of a licensee that makes a retention election do not extend to intellectual property that first comes into existence after commencement of the licensor's bankruptcy case, a novel issue is raised with respect to patent applications pending at the time of the bankruptcy filing. This issue is whether a patent that issues after commencement of the case on a patent application pending at the time of commencement of the case would be within the license rights deemed to exist immediately before the filing and preserved if the licensee makes a retention election under §365(n)(1)(B).

Given that the invention covered by a patent application pending on the date of bankruptcy would have existed before the bankruptcy filing and that patent applications are specifically included in the definition of "intellectual property" in Bankr C §101(35A), a licensee should have a strong argument that a patent that issues on an application pending when the bankruptcy case was filed should be deemed to be in existence at that time and therefore should be protected under §365(n)—particularly if the patent prosecution was substantially complete at the time of the filing (*e.g.,* if a notice of allowance had already been issued by the PTO). Indeed, including patent applications in the definition of "intellectual property" protected under §365(n) would be meaningless if the patents that issue on the applications postpetition were not also protected, because the applications do not convey any enforceable patent rights before patent issuance.

The prosecution of a patent application, however, may involve postpetition expenditures of tens of thousands of dollars of attorney fees and expenses by the debtor-licensor. A bankruptcy court could conclude that the licensee should not stand to benefit from such postpetition activity. If substantial prosecution activity occurs after commencement of the bankruptcy case, inclusion of the fruits of these postpetition efforts—*i.e.,* the patent ultimately granted by the PTO—is arguably inconsistent with (1) the fresh start policy underlying the mandate of §365 that the debtor not be burdened with any affirmative postpetition obligations under any rejected agreement and (2) the corollary principle that protection under §365(n) should extend only to the licensed intellectual property as it existed immediately before commencement of the case.

NOTE: The fact that a license retained by a licensee who has made the retention election extends to a patent issuing after commencement of the case does not imply that the licensee is permitted to enforce any obligation of the debtor under the rejected license agreement to seek and obtain an issued patent on the pending application. Any such obligation would not be specifically enforceable following rejection. See §12.22.

There are apparently no reported cases addressing whether a patent that issues after commencement of the licensor's bankruptcy case on a patent application pending at the time the case is commenced would be protected by §365(n). For nonexclusive patent licenses, it seems unlikely that a court would find that rejection operated to divest a licensee making the retention election of any right to practice such a patent, making the licensee liable to the debtor for infringement damages if the licensee practices the patent following its issuance. Such a result would be contrary to the purposes of §365(n) and would appear to create a windfall for the debtor or its successor. (The debtor or its successor could insist on a royalty or other consideration from the licensee, even though the licensee had made the election to retain its rights in the intellectual property existing when the case is commenced, *i.e.,* its rights in the invention itself and the inchoate patent rights under the patent application.)

In contrast, if the license in question is an exclusive license, it appears more likely as a practical matter that a court would hold that the rights retained by a licensee making the retention election would not include a patent issued postpetition. The value to the bankruptcy estate of recapturing such exclusive rights could be relatively significant, and bankruptcy courts often seem predisposed to rule in a debtor's favor in such a context. As in the case of a nonexclusive license, however, this result appears inconsistent with the policy underlying §365(n) to protect the licensee from being stripped of rights in intellectual property developed by the debtor-licensor prior to bankruptcy.

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§12.37 (3) Contingent License Grants

It is generally assumed by commentators that contingent license rights that have not become effective at the time a bankruptcy case is commenced are not protected by Bankr C §365(n). See, *e.g.,* Lesser, "Bankruptcy and Licensing," 571, 591, PLI Ninth Annual Institute for Intellectual Property Law (2003). A plain reading of §365(n)(1)(B) certainly supports this view. If the event that must occur in order for license rights to spring into effect has not occurred when the bankruptcy case is filed, the license would not seem to represent rights that were then in existence. Under this view, a licensee that wants to ensure that the protections of §365(n) apply must insist on a presently effective (unconditional) license grant by the licensor. The only published case that appears to have addressed the application of §365(n) to a contingent license grant is consistent with this view. In *In re Storm Technol., Inc.* (Bankr ND Cal 2001) 260 BR 152, the bankruptcy court held that a contingent patent license that was to spring into effect on a payment default by the debtor was not protected by §365(n) because the payment default did not occur until after the bankruptcy petition had been filed and therefore the license was not in existence at the time of commencement of the case.

If the business understanding of the parties is that a licensee is permitted to exercise the license rights only on the happening of a specified future event, it may be difficult to structure a presently effective license grant. One possibility is to deposit the embodiments of the intellectual property subject to the license in an escrow under which the embodiments are not made available to the licensee until the relevant future event occurs. In this situation, the fact that the license grant is presently effective should raise no significant concerns. For a patent license or other arrangement in which the subject matter of the license is readily accessible to the licensee, the licensee can covenant not to exercise the license before the occurrence of the specified future event, or else agree to pay an incremental royalty or other compensation to the licensor if the license rights are exercised before the event. Such covenants should minimize the possibility that the rights would be exercised prematurely by the licensee, or at least provide appropriate compensation if they are. These arrangements, however, can be cumbersome, may be ineffective if tied to an insolvency or bankruptcy condition, and otherwise may complicate the ability of the parties to implement a contingent license in a mutually acceptable manner that protects the interests of both the licensor and the licensee.

The legislative history suggests that Congress in fact desired to limit the protections of §365(n) to intellectual property (and related embodiments) in existence at the time of bankruptcy, but did not intend to withhold protection from contingent licenses granted prior to bankruptcy, whether or not the trigger event that made the contingent license effective had occurred before commencement of the case. The legislative history discusses this issue as follows (S Rep No. 100-505, 100th Cong, 2nd Sess 8 (1988), reprinted at 1988 US Code Cong & Ad News 3200, 3205):

> It is important to note that the amendment, when referring to retention of rights under "such contract," deliberately omits the phrase "the term of which has commenced" appearing in the somewhat parallel sub§365(h) in connection with leases and time share plans. Frequently, the term of the license agreement is contingent upon the occurrence of a future event, such as FDA approval or issuance of the patent. The benefits of the bill are intended to extend to such license agreements, consistent with the limitation that the licensee's rights are only in the underlying intellectual property as it existed at the time of the filing.

See also 3 Collier on Bankruptcy ¶365.14[1][a] (15th ed rev 1996).

Interpreting §365(n) to deny its protections to contingent license grants that are not yet effective at the time of bankruptcy but which relate to intellectual property that is then in existence in no way furthers the fresh start policy underlying the distinction made by §365(n) between rights existing before commencement of a bankruptcy case and those arising afterwards. Nevertheless, until §365(n) is amended or a body of case law develops that gives effect to Congress's stated intent, licensees desiring the benefits of §365(n) should not accept contingent license grants, but rather should insist on presently effective licenses (if necessary, coupled with a covenant not to exercise or other mechanism giving the licensor comfort that the license will not be exercised before the occurrence of any agreed triggering event).

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4. Selected Issues Under §365(n)

§12.38 a. Licenses Bundled With Trademark Rights

Another area of confusion regarding the operation of Bankr C §365(n) is how the retention election applies if a license includes within its scope both trademark rights—which are not included in the definition of "intellectual property" under Bankr C §101(35A) and therefore not protected under §365(n)—and intellectual property rights that are protected under §365(n). The question presented in this context is whether trademark rights that form an integral part of a license that also includes patents, trade secrets, or copyrights should be preserved when a retention election is made by the licensee following rejection of the license agreement. License agreements often include grants of intellectual property rights covering both technology (*i.e.,* patents, trade secrets, or copyrights) and trademark (or related) rights. Nonetheless, there appears to be no published case squarely holding that a trademark license that is integral to a technology license either should or should not survive rejection along with the licensed patents, trade secrets, or copyrights that are retained if the licensee makes the retention election. One case, in dicta, suggested that a trademark license should survive in such circumstances. See *In re Ron Matusalem* (Bankr SD Fla 1993) 158 BR 514.

There are strong arguments that a trademark license bundled with other licensed rights should be preserved along with the other licensed rights following a retention election by the licensee, as follows: (1) the stated legislative purpose of Bankr C §365(n) to prevent licensees from losing existing licensed intellectual property rights on rejection of the underlying license agreement; (2) Congress's invitation to bankruptcy courts to address the effect of a rejection of trademark licenses in an equitable manner on a case-by-case basis; and (3) the extent of the harm that a licensee would suffer if a trademark license that was integral to a technology license could not be preserved with a related technology license that is the subject of a retention election, in relation to any benefit that would accrue to the bankruptcy estate from extinguishing the trademark license in this context.

NOTE: For a sample clause designed to enhance the ability of a licensee holding such a bundled license to preserve its trademark rights along with the protected patent, copyrights, or trade secrets when making a retention election, see §12.80.

A very unfavorable outcome for a licensee with bundled technology and trademark license rights would be for the licensee to lose its §365(n) rights to the technology part of a license grant on grounds that a single integrated set of license grants should stand or fall together. There is apparently no published decision holding that the protections afforded patents, copyrights, or trade secrets under §365(n) could fall away if those rights were licensed with trademarks under a single integrated license grant. It seems improbable that a court would rule that none of the bundled rights would be preserved by the retention election, rather than severing the trademark license from the other licensed rights or holding that the trademark license survives as an integral part of the entire license grant. Accordingly, it does not appear advisable to place trademark rights in a separate trademark license document in order to prevent the other intellectual property rights licensed with the trademark rights from being "tainted" by the trademark rights. Such a strategy would likely eliminate any ability to argue that the trademark license should survive along with the other intellectual property rights in a retention election, as an integral part of the entire licensing transaction.

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§12.39 b. Subsequent Court Sale of Licensed Intellectual Property

Notwithstanding the apparently unqualified protection afforded a licensee that makes a retention election under Bankr C §365(n), the Seventh Circuit has held that a licensee's retained rights under §365(n) after making the retention election can be cut off by a subsequent sale of the licensed intellectual property in the debtor's bankruptcy case under Bankr C §363(f). Bankruptcy Code §363(f) permits the debtor to sell property of the estate free and clear of all claims and interests, subject to certain conditions. In *FutureSource LLC v Reuters Ltd.* (7th Cir 2002) 312 F3d 281, 285, the debtor sold certain intellectual property that was the subject of a license agreement rejected by the debtor, after which the licensee had made the retention election. The licensee apparently received notice of the sale, but did not timely object to it. It is not clear whether the court would have found that the license could not be extinguished in the sale if the licensee had timely objected. Even if the licensee had objected, it is possible that the court might have found that the license could be extinguished under §363(f)(5), which allows the debtor to sell property of the estate free and clear of the interest of a third party if the third party could be compelled in a legal or equitable proceeding to accept a money satisfaction of the interest. See also *Top Rank, Inc. v Ortiz (In re Ortiz)* (CD Cal 2009) 400 BR 755 (finding §365(f) order authorizing sale of intellectual property free of licensee's retained license rights under §365(n) void as to licensee's license rights because of lack of notice to licensee, and suggesting that licensee could have prevented transfer of the intellectual property free of licensee's retained rights if licensee had timely objected to the sale); *Precision Indus., Inc. v Qualitech Steel SBQ*, *LLC (In re Qualitech Steel Corp.)* (7th Cir 2003) 327 F3d 537 (debtor permitted to sell real estate free and clear of interest of lessee who had elected under §365(h) to retain possession of leased premises after debtor's rejection of lease under §365).

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§12.40 c. Effect of Completed Assignment

The Copyright Act of 1976 (the Copyright Act) (17 USC §§101-810) provides that copyright ownership is divisible, and that the holder of an exclusive license is a copyright "owner" to the extent of the exclusive right transferred. The Copyright Act further provides that a "transfer of copyright ownership" includes, among other things, an exclusive license and "any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect." 17 USC §101. In addition, the Copyright Act provides (17 USC §201(d)(2)):

> Any of the exclusive rights comprised in a copyright, including any subdivision of any of the rights specified by §106, may be transferred… and owned separately. The owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by this title.

A licensee's obligations following rejection of an agreement containing an exclusive copyright license may differ depending on whether an exclusive copyright license is viewed as a completed transfer of a property interest. Because the debtor-licensor's rejection affects only the executory obligations under a contract, and does not rescind or otherwise affect completed property transfers, an assignment of any of the exclusive rights that comprise copyrights should not be affected in any way by the rejection of the underlying executory contract under which the assignment was made.

NOTE: If the grant of an exclusive copyright license is viewed as an assignment rather than a covenant not to exercise or grant any rights within the scope of the exclusive rights of copyright (see 17 USC §106), the license might be characterized as an executed, rather than an executory, contract. Given the relatively insignificant obligations that have been found sufficient to create the "executoriness" required for an agreement to constitute an executory contract under §365, however, such a license would still likely be found to constitute an executory contract. See, *e.g., Fenix Cattle Company v Silver (In re Select-A-Seat Corp.)* (9th Cir 1980) 625 F2d 290, 292. See also *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702; *Lubrizol Enters. v Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)* (4th Cir 1985) 756 F2d 1043, 1045, cert denied (1986) 475 US 1057; *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300, 309.

Even if an exclusive license of a copyright is not treated as a completed transfer of ownership, the rights of an exclusive licensee under a rejected license agreement would be protected through a retention election under §365(n). In this event, however, the licensee would be required to continue to pay any royalty or other fee due in consideration of the grant of the exclusive rights without setoff (see §12.25) as a condition to making the retention election. In contrast, if a completed assignment was made prior to bankruptcy, the assignee is permitted to retain the assigned intellectual property without being subject to the requirement that royalties must continue to be paid to the debtor without setoff. The assignee would thus be permitted to offset any damage claims it might have that are attributable to any breaches by the debtor-assignor of any unperformed obligations, such as an obligation to provide technical support or indemnification.

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d. Source Code Escrows

§12.41 (1) Generally

As discussed in §§12.23-12.24, after commencement of a bankruptcy case, the debtor-licensor is obligated under Bankr C §365(n) to provide the licensee with any intellectual property (including embodiments) licensed under a prebankruptcy license agreement, to the extent that the debtor is obligated to do so under the agreement. This obligation continues unless the license agreement is rejected and the licensee does not make the retention election. 11 USC §365(n)(3)-(4). In view of the statutory requirement that the licensor carry out any obligation it has under the license agreement to deliver embodiments of intellectual property to the licensee, an escrow agreement arguably is not required to address the licensee's concern to have access to source code or other licensed technology after the bankruptcy filing. Nevertheless, it is possible that the debtor might not cooperate in providing source code or other technology, and there is no absolute assurance that the licensee could obtain immediate relief from the bankruptcy court. Source code (or other technology) escrows therefore provide an additional level of protection in a bankruptcy context, as well as serving important functions outside of bankruptcy. (A licensee also needs to access source code if the licensor ceases its business operations or otherwise fails to provide essential technical support to the licensee.)

PRACTICE TIP: There is no assurance that the escrow deposit(s) made by the licensor prior to bankruptcy will be up-to-date and include all the materials that the parties agreed would be deposited into escrow. If the licensor is not required to update the escrow deposit periodically, or if the licensor is so obligated but does not comply, the licensee may find that the source code deposited into escrow is obsolete or otherwise inadequate to enable the licensee to utilize effectively the then-existing form of source code. The license agreement should therefore include a covenant by the licensor to provide directly to the licensee, on the occurrence of the relevant release events, an updated, complete version of the source code in the event that the escrowed materials are not up to date or complete for any reason.

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§12.42 (2) Bankruptcy Law Issues

A number of bankruptcy law issues are raised by the structuring and operation of source code escrows or other arrangements by which a licensee seeks to enforce its right to receive or access licensed technology under a prebankruptcy license agreement. These include (1) the licensee's ability to preserve its license rights in escrowed materials if the license has not become effective before commencement of the bankruptcy case (discussed in §12.43); (2) the possible treatment of a technology escrow agreement as an executory contract subject to rejection under Bankr C §365, under which no rights or obligations of any party (including, *e.g.,* the right of access to escrowed material on the occurrence of a trigger event) could be modified based on the licensor's bankruptcy or financial condition (discussed in §12.44); and (3) the applicability of the automatic stay to an attempt by a licensee to obtain possession of embodiments of licensed technology, either directly from the debtor or through the release of materials held in escrow for a licensee's benefit (discussed in §12.45). Some considerations in structuring effective source code escrows are discussed in §12.46.

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§12.43 (a) When Contingent License Ineffective Prior to Bankruptcy

As discussed in §12.37, when the licensee makes a retention election, Bankr C §365(n) appears to preserve only those license rights in existence immediately prior to bankruptcy. Therefore, a licensee should insist on receiving a presently effective license grant for escrowed material so that, if the license grant is included in an agreement found to constitute an executory contract, the license will survive rejection under §365(n). Accordingly, the license grant should include "hereby grant" terminology, and its effectiveness should not be subject to the occurrence of an escrow release or other future event. For suggested license grant language, see §12.86. Licensor concerns regarding the present effectiveness of the license grant (before the occurrence of the agreed release event) should be alleviated if the licensor recognizes that, notwithstanding the present effectiveness of the license grant, the licensee is incapable of exercising rights to the escrowed source code until it is released from escrow.

A licensee may, however, insist on having a unilateral right to trigger an escrow release within a specified number of days after written notice. Time may be of the essence in obtaining source code, and a licensee may be concerned that a licensor, perhaps in bad faith, might give a counter-instruction to an escrow agent, thereby preventing release of the escrowed material unless the licensee is willing to buy the licensor's cooperation. If the licensee negotiates such a unilateral right, the escrow agreement will require the escrow agent to release the escrowed source code regardless of whether the licensor has delivered a counter-instruction or other objection to the requested release. If the licensor disputes whether an escrow release event has occurred, the licensor's only remedies would be to promptly seek injunctive relief to enjoin the release or to assert a breach of contract damages claim against the licensor. (It is not unusual for license agreements to include a reciprocal clause that excludes any right to recover consequential damages for a breach by either party, and such a clause could limit significantly the licensor's recoverable damages in this context.)

Escrow agreements typically require the escrow agent to release the escrowed materials within a relatively short time after notice has been given to the depositor that the beneficiary of the escrow is seeking a release. The number of days' prior notice usually will not exceed 10, and may be less than 10. To alleviate a licensor's concern that the licensee may trigger a release prematurely, a liquidated damages clause can be included in the license agreement that would require the licensee to pay the licensor a substantial sum as liquidated damages if the licensee is found to have wrongfully triggered an escrow release. See §12.86.

NOTE: If the liquidated damages clause is included in the license agreement, or if it is included in the escrow agreement and the escrow agreement is found to be an executory contract subject to rejection under Bankr C §365, the liquidated damages clause may be rendered unenforceable as a result of the rejection. See, *e.g., In re EI Int'l* (Bankr D Ida 1991) 123 BR 64; *In re Transamerican Natural Gas Corp.* (Bankr SD Tex 1987) 79 BR 663. But see *In re Independent Am. Real Estate, Inc.* (Bankr ND Tex 1992) 146 BR 546 (liquidated damages clause in executory contract enforced notwithstanding rejection of contract). Given the conflict in the case law, the post-rejection enforceability of a liquidated damages clause is uncertain, but the decisions in which liquidated damages clauses have been found enforceable following rejection appear to be better reasoned.

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§12.44 (b) Possible Treatment as Executory Contract

It is generally desirable to minimize the possibility that an escrow agreement could be characterized as an executory contract, even though Bankr C §365(n) and the legislative history suggest that an escrow beneficiary should be entitled to possession of the embodiments of licensed intellectual property deposited in escrow prior to bankruptcy even if the escrow agreement is rejected. At this writing, there appear to be no reported cases involving rejection of a source code (or other technology) escrow agreement under §365 by a licensor. In the absence of case law, the effect of rejection on the escrow beneficiary's rights to obtain possession of the escrowed materials is not clear. In addition, if an escrow agreement is treated as an executory contract, Bankr C §365(e) would render ineffective any escrow release event based on the depositor-licensor's bankruptcy or financial condition.

Some commentators (see*, e.g.,* Patel, "Software Escrows as Part of an Intellectual Property Strategy" p 3 (Fenwick & West LLP, 2005), available at http://www.fenwick.com/publications/6.0.0.asp) have suggested that a bankruptcy-related release event in an escrow agreement will always be ineffective by operation of Bankr C §365(e). See §12.15. Section 365(e), however, has no application to an agreement that is not an executory contract. To minimize the possibility that an escrow agreement could be characterized as an executory contract, it is advisable to place the license grant covering the escrowed materials in the license (or another) agreement to which the escrowed materials relate, rather than in the escrow agreement. It is also advisable to eliminate any other executory obligations of the debtor-licensor from the escrow agreement, including any obligation to periodically update the escrowed materials and any monetary obligations (such as an obligation to pay escrow fees and to indemnify the escrow agent against losses and expenses associated with the escrow agent's performance). The debtor-licensor's covenant to update the escrowed materials can be placed in the underlying license agreement, and any responsibility of the debtor-licensor for escrow fees or indemnifiable losses or expenses can be addressed in the license agreement (or another agreement separate from the escrow agreement).

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§12.45 (c) Applicability of Automatic Stay

Another unresolved issue in the context of technology escrows is whether the automatic stay of Bankr C §362 (see §12.5) applies to the giving of notice to an escrow agent of the occurrence of an escrow release event. There are apparently no published cases that address the applicability of the automatic stay in this context. An argument can be made, however, that an attempt to trigger a release from escrow is an attempt to take possession of property of the estate subject to the automatic stay. The likelihood that the automatic stay could be found applicable (or that the bankruptcy court would interfere with other aspects of the escrow agreement) should be minimized if the escrow agreement provides that the documentation, CDs, or other tangible materials deposited into escrow by the licensor are owned by the escrow agent until such time as they are released to the escrow beneficiary, with the licensor having no contingent possessory or other interest in such materials. If the escrow agreement so provides, the escrowed materials would never be returned to the licensor, but would be destroyed at the time of termination of the escrow agreement if not previously released to the licensee-beneficiary. Moreover, if the escrow agreement provides that the tangible media embodying the escrowed materials is owned by the escrow agent, the release of such media should not be considered a transfer of property of the estate that would be ineffective under Bankr C §541(c)(1) as a transfer or forfeiture of the debtor-licensor's property on commencement of the debtor's bankruptcy case.

Bankruptcy Code §365(n)(3) expressly requires a debtor-licensor to comply with any obligation to deliver, and not to interfere with the licensee's rights to, embodiments of licensed intellectual property under the terms of any "supplemental" agreement such as an escrow agreement. See generally §§12.23-12.24. It therefore appears to be an unnecessary burden on a licensee's rights under §365(n) to require the licensee to seek relief from the automatic stay before exercising rights that are enumerated in §365(n). Nevertheless, unless the debtor agrees not to assert a violation of the automatic stay if a licensee triggers an escrow release without first obtaining relief from stay, the licensee should consider seeking relief from stay, particularly if the licensee does not require access to the escrowed materials on an emergency basis.

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§12.46 (3) Structuring Effective Source Code Escrows

The following steps should be taken by a licensee to minimize the likelihood of bankruptcy court interference in the postbankruptcy operation of a source code escrow and to optimize the benefits afforded by a source code escrow arrangement:

- The escrow agreement should be stripped of any affirmative performance obligations on the part of the debtor-depositor, so that it will not be treated as an executory contract subject to rejection under Bankr C §365 (see §12.44);
- Although a bankruptcy or insolvency escrow release event should be effective if the escrow agreement is drafted in a manner consistent with the preceding point, a licensee should always strive to include other release events, such as an uncured breach of the licensor's development or support obligations or the cessation of operations in the ordinary course. Doing so should enable the licensee to access the escrow in appropriate circumstances outside of bankruptcy, as well as in the event the licensor challenges release of the source code when a bankruptcy or insolvency escrow release event occurs, on grounds that the escrow agreement is an executory contract to which Bankr C §365(e)(1) applies (see §12.15);
- The escrow agreement should vest title to the tangible copy of the media containing the source code that is deposited into escrow in the escrow agent (see §12.45);
- The escrow agreement should provide that, at the time of termination of the escrow, the tangible copy of the source code is destroyed rather than returned to the licensor, thus minimizing the ability of a debtor-licensor to argue that the copy constitutes property of the bankruptcy estate over which the bankruptcy court has exclusive jurisdiction (see §12.45);
- The debtor-licensor should have an obligation to deliver the source code directly to the licensee at the licensee's request following the occurrence of a release event in case there is a problem obtaining access to the source code through the escrow or if the source code is not up to date or complete;
- The right to use the source code should be subject to a present license grant, which should preclude a debtor-licensor from arguing either that the license is a springing license not protected by §365(n) because it did not exist immediately prior to bankruptcy (see §§12.32, 12.37, 12.43) or that the source code license is triggered by an "ipso facto" bankruptcy clause that is invalidated by either Bankr C §365(e) or §541(c) (see §§12.15, 12.45). As indicated above, if a licensor has concerns about the licensee's exercise of license rights before the occurrence of an escrow release event, the licensee can, if necessary, agree not to exercise its rights before a release event. This should not be necessary, however, because the licensee will be incapable of exercising the license rights until the licensee obtains possession of the source code following its release from escrow;
- The source code license grant should include the right not only to correct bugs and errors in the licensed software (to which a licensor should never object), but also an unrestricted right to make enhancements and other modifications (to which a licensor sometimes does object); and
- The licensee should seek to have escrowed materials include the identity and contact information of the principal developers of the licensed software, along with an express right in the license agreement to solicit the employment of such individuals following occurrence of a release event.

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§12.47 5. Fraudulent Transfer Risk

Although a license may be protected under Bankr C §365(n) in connection with a rejection by the licensor under §365, a license may be vulnerable to attack under other provisions of the Bankruptcy Code. For example, if a license is treated as a transfer of an interest in property, a license could be subject to attack in bankruptcy proceedings as a fraudulent transfer under Bankr C §548. A transfer of an interest in property can be avoided by a bankruptcy debtor either on the basis that the transfer was made with actual intent to defraud creditors or if it is deemed to be a "constructive" fraudulent transfer based on certain objective tests, irrespective of the debtor's intent. Under Bankr C §548(a)(1)(B) (and applicable state law; see CC §3439.04), a prebankruptcy transfer constitutes a constructive fraudulent transfer if (i) the debtor receives less than a "reasonably equivalent value" in exchange for the transfer, and (ii)(A) the debtor is insolvent or becomes insolvent as a result of the transfer, (B) the debtor was engaged in business, or about to engage in business or transactions, for which the property remaining was an unreasonably small capital, or (C) the debtor intended to incur, or believed it would incur, debts beyond its ability to pay as they matured. 11 USC §548; CC §3439.04.

Whether a license grant constitutes a constructive fraudulent transfer depends on certain factual determinations about the value exchanged by the parties in the license transaction and the debtor's financial condition at the time of the grant. The three alternative financial condition tests in Bankr C §548(a)(1)(B)(ii) are applied based on the fair value of assets rather than book value determined in accordance with generally accepted accounting principles. Fair value includes the expected amount (based on reasonable assumptions) of contingent and unliquidated liabilities, whether or not the liabilities appear on the debtor's balance sheet. See generally *Moody v Security Pacific Business Credit* (3d Cir 1992) 971 F2d 1056; *Credit Managers Assoc. v Federal Co.* (CD Cal 1985) 629 F Supp 175.

Subject to certain limitations, a debtor could seek to avoid a license as a constructive fraudulent transfer any time up to 4 years after the time of the transfer under state law (see CC §3439.09(a)), although the period under Bankr C §548 is 2 years before commencement of the bankruptcy case (see 11 USC §548(a)(1)). If a license is avoided as a fraudulent transfer, the license is in effect rescinded. The licensee would then have a claim against the bankruptcy estate based on the value it exchanged for the license, and, if the licensee is found to have acted in good faith, it may be entitled to assert a lien against the license rights that revert back to debtor. See 11 USC §548(c).

It appears likely that an exclusive license of any type of intellectual property would be deemed an interest in property subject to possible attack as a fraudulent transfer. A nonexclusive license, however, is usually considered a personal (and nontransferable) right of the licensee. It is uncertain whether a nonexclusive license should be treated as a property interest subject to avoidance as a fraudulent transfer. A good argument can be made, however, that a nonexclusive license (particularly a nonexclusive patent license—which is essentially a covenant not to sue and does not necessarily entail the delivery by the licensor of any embodiments of licensed materials) should not be subject to attack as a fraudulent transfer because it does not represent an interest in property. See §12.20.

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§12.48 6. Risk of Invalidation Under §544(a)

In addition to the fraudulent transfer risk discussed in §12.47, an exclusive intellectual property license may also be vulnerable to attack in certain circumstances under what is known as the "strong arm" power under Bankr C §544(a). Section 544(a) permits either the debtor in possession in a Chapter 11 case or the bankruptcy trustee to avoid (*i.e.,* invalidate) unperfected security interests and other unrecorded property transfers that would be subject to avoidance by a hypothetical judicial lien creditor. In effect, §544(a) authorizes the debtor to invalidate any unrecorded property transfer made by the debtor before bankruptcy if the lack of recording means that the transferee's rights in the property would be subject to the rights of a creditor that acquires a judicial lien on the property as of the date of commencement of the bankruptcy case.

The strong arm power under §544(a) presents a risk to a licensee in connection with a licensor bankruptcy only if the rights granted to the licensee are subject to recording requirements under applicable intellectual property law. See §§12.49-12.51. If those requirements are not satisfied, a hypothetical judicial lien creditor of the licensor that enforced its lien rights against the intellectual property could cut off the licensee's unrecorded license rights.

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§12.49 a. Copyright Licenses

Section 101 of the Copyright Act defines a "transfer of copyright ownership" to include "an assignment, mortgage, exclusive license, or any other conveyance, alienation or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright." 17 USC §101. Nonexclusive copyright licenses are not included in this definition. Section 205 of the Copyright Act provides for the recordation of transfers of copyright ownership as follows (17 USC §205(d)):

> *Priority Between Conflicting Transfers*. As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States… or at any time before recordation in such manner of the later transfer. Otherwise, the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

There are apparently no reported cases in which an unrecorded exclusive copyright license has been attacked under Bankr C §544(a). Several published cases, however, have addressed whether an unrecorded security interest in copyrights may be avoided under Bankr C §544(a). For example, in *National Peregrine, Inc. v Capitol Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194, the court held that a security interest in a copyright for which a UCC-1 financing statement had been filed but no recordation had been made in the U.S. Copyright Office in compliance with 17 USC §205(d) could be avoided under 11 USC §544(a)(1). In *Aerocon Eng'g Inc. v Silicon Valley Bank* (*In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120, however, the Ninth Circuit distinguished *Peregrine,* holding that security interests in copyrights that have not been registered with the U.S. Copyright Office are perfected by a UCC-1 financing statement filing alone, but that security interests in registered copyrights can be perfected only by recording an appropriate security agreement in the U.S. Copyright Office.

Although there are no published cases on point, it appears likely, based on the *Aerocon Engineering* reasoning, that an exclusive license of a registered copyright that has not been recorded under 17 USC §205(d) by the time of commencement of the licensor's bankruptcy case could be invalidated by the licensor under Bankr C §544(a). If the exclusive license covers an unregistered copyright, however, any filing by the licensee in the U. S. Copyright Office would be of no effect and, consistent with *Aerocon Engineering,* an exclusive license of an unregistered copyright that has not been recorded should not be vulnerable to attack under Bankr C §544(a).

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§12.50 b. Patent Licenses

Title 35 USC §261 provides a recordation and priority scheme for any assignment, grant, or conveyance of a patent. Licenses can also be recorded at the discretion of the U.S. Patent and Trademark Office (PTO) under 37 CFR §3.11(a), but recording a license may not serve as constructive notice under §261. See 37 CFR §3.54. Section 261 does not indicate whether a license is an "assignment, grant or conveyance" to which the recording requirements of §261 apply. Courts have held, however, that an exclusive patent license for the term of the patent may constitute an assignment of a patent. See, *e.g., Lamar v Granger* (WD Pa 1951) 99 F Supp 17, 36 (exclusive license for life of patent is an assignment); *American Type Founders v Dexter Folder Co.* (SD NY 1943) 53 F Supp 602, 604 (exclusive agreement granting license for remaining term of patent constituted an assignment).

There are apparently no reported cases in which an unrecorded exclusive patent license has been attacked under Bankr C §544(a). There are, however, several published cases addressing whether an unrecorded *security interest* in a patent may be avoided under Bankr C §544(a). Those cases uniformly hold that a security interest that has not been recorded in the PTO but has been perfected by filing a UCC-1 financing statement under Article 9 of the Uniform Commercial Code cannot be invalidated under Bankr C §544(a). See *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied (2002) 534 US 1130 (federal patent law does not preempt state law regarding perfection of security interests in patents, because Patent Act recording provisions address only transfer of "ownership" interests in patents, and security interest in patent is not assignment for purposes of 35 USC §261); *In re Transp. Design & Technol., Inc.* (Bankr SD Cal 1985) 48 BR 635 (secured creditor that filed UCC-1 financing statement not required to record security interest in PTO to perfect security interest as against bankruptcy trustee); *City Bank & Trust Co. v Otto Fabric, Inc.* (D Kan 1988) 83 BR 780 (recordation of security interest in PTO was unnecessary to perfect security interest in patents as against lien creditors).

Based on these cases, it appears that a judicial lien creditor should not be senior in priority over an unrecorded exclusive licensee under 35 USC §261, and therefore a debtor licensor should not be able to invalidate an unrecorded exclusive patent license under Bankr C §544(a). Nevertheless, given the possible treatment of an exclusive license as an assignment for purposes of 35 USC §261, an exclusive licensee should record its exclusive license in the PTO to eliminate the possibility that the license could be invalidated in a later bankruptcy of the licensor. Recording is also essential to assure the licensee's priority over a subsequent assignee of the licensed patent.

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§12.51 c. Trademark Licenses

For trademarks, the analysis is essentially the same as discussed in §12.50 for patents. Title 15 USC §1060 provides for recording of assignments of registered trademarks but does not address whether licenses of registered marks are subject to the same recordation and priority provisions. See also 37 CFR §3.11(a) (providing for the recording of assignments of registered marks and registration applications). Unlike 35 USC §261, which addresses priority disputes involving both subsequent purchasers and mortgagees of patents, 15 USC §1060 only addresses priority disputes involving subsequent purchasers of registered trademarks. Accordingly, §1060 would apply to an exclusive license only if, for purposes of §1060, an exclusive license were treated as an assignment and "purchaser" were construed to include a hypothetical judicial lien creditor. Case law is conflicting regarding whether an exclusive trademark license may be considered an assignment for purposes of §1060. See *Ste. Pierre Smirnoff, Fls., Inc. v Hirsch* (SD Cal 1952) 109 F Supp 10, 12 (exclusive license to use mark in designated territory constitutes assignment). But see *Estate of Presley v Russen* (D NJ 1981) 513 F Supp 1339, 1350 (exclusive right to use of trademark that is limited as to duration or area is not assignment).

There appear to be no published cases in which an unrecorded exclusive trademark license has been attacked under Bankr C §544(a). Courts in several published cases, however, have addressed the issue whether the recordation of a security interest under §1060 of the Lanham Act (15 USC §1060) is necessary or sufficient in order for the security interest to be invulnerable to attack under Bankr C §544(a). Consistent with the cases considering the analogous issue under §261 of the Patent Act (35 USC §261) (see §12.50), these cases uniformly hold that recordation of a security agreement under 15 USC §1060 is not necessary to render the security interest invulnerable to attack under the strong-arm powers of Bankr C §544(a). See, *e.g., Joseph v 1200 Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778 (recordation of security agreement in PTO did not perfect security interest in registered trademark, distinguishing *Peregrine* on the basis that, unlike the Copyright Act, the Lanham Act definition of assignment does not include security interests); *Roman Cleanser Co. v National Acceptance Co. (In re Roman Cleanser Co.)* (Bankr ED Mich 1984) 43 BR 940, aff'd (6th Cir 1986) 802 F2d 207 (filing appropriate UCC-1 financing statement sufficient to perfect security interest in registered trademarks); *Creditors' Comm. of TR-3 Indus., Inc. v Capital Bank (In re TR-3 Indus.)* (Bankr CD Cal 1984) 41 BR 128, 131 (security interest in trademarks perfected by filing UCC-1 financing statement). These cases indicate that an exclusive trademark license that has not been recorded in the PTO should not be subject to avoidance under Bankr C §544(a). A prudent exclusive licensee of a registered trademark nevertheless may wish to eliminate any such risk by recording its exclusive license in the PTO.

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§12.52 7. Drafting and Structuring Issues

A licensee desiring to mitigate the risks associated with rejection of a license agreement under Bankr C §365 in a bankruptcy of the licensor should consider the desirability or feasibility of the steps discussed in §§12.53-12.57.

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§12.53 a. Acknowledgement of Applicability of Bankr C §365(n)

Virtually all commentators urge licensees to include in their intellectual property license agreements language acknowledging that the licensed rights constitute rights to "intellectual property" as defined under Bankr C §101(35A) and that, if the license agreement is rejected by the licensor in a bankruptcy case, the licensee will be entitled to exercise all of its rights and elections under Bankr C §365(n). For sample language, see §12.79. Commentators often imply that such an acknowledgement is required in order for a licensee to obtain the benefits of §365(n). In an ordinary software or other technology license agreement, however, such an acknowledgement is not necessary, given that the application of §§101(35A) and 365(n) is straightforward and nothing in §365(n) requires a license agreement to include special terminology in order for a licensee to have the benefit of §365(n). On the other hand, if the license agreement raises issues about which there is some uncertainty under §365(n), *e.g.,* if the license is a "bundled" license that includes both trademarks rights and rights that qualify as "intellectual property" under Bankr C §101(35A) (see §12.38), language expressing the intent of the parties that the entire license be protected by §365(n) should be helpful, even though there is no assurance that a bankruptcy court would give effect to such language. For sample language, see §12.80.

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§12.54 b. Unbundling of Fees

If a license agreement includes a bundled fee covering both the license grant and maintenance, technical support, or other services, the licensee should endeavor to unbundle the fee so that there are separate fees allocable to the grant of license rights and to the performance of services. This bifurcated fee arrangement should result in limiting the licensee's postrejection payment obligations to the amount allocated to the license fee—thereby avoiding the inequity of having to pay a debtor-licensor after rejection of the agreement for services that are no longer being provided. See §12.81 for a sample clause.

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§12.55 c. Provision of Embodiments

Licensees often need access to certain intellectual property, such as source code, to be able to continue to use a licensor's products or technology in the event that the licensor fails to perform its obligations under the license agreement (*e.g.,* if the licensor files bankruptcy or ceases its operations). In such circumstances, it is important for the licensee to make arrangements in advance so that it will have access to this intellectual property at the relevant time.

In addition to any escrow arrangement that is implemented (see §§12.41-12.46), a software licensee should ensure that the license agreement requires the licensor to provide the licensee with an up-to-date version of the source code for the licensed software on the occurrence of specified release events. If the agreement provides for the licensor to be obligated to do so, the licensee will have an enforceable right under Bankr C §365(n) to require the licensor to deliver the source code directly to the licensee in the event that the materials deposited into escrow prove to be inadequate for any reason. For a sample clause, see paragraph 1(e) in §12.86. An obligation to provide source code or other technology in a license agreement (or other executory contract) triggered by commencement of a bankruptcy case would not be enforceable under Bankr C §365(e)(1). See §12.15.

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§12.56 d. Security Interests

A technique often used by licensees before enactment of Bankr C §365(n) to lessen the risk of rejection of a license agreement, which continues to provides helpful protection even in the context of the protections afforded by Bankr C §365(n) , is for the licensee to obtain a security interest in the licensed intellectual property (or other available collateral) to secure the licensor's obligations under the agreement. Because trademark licenses are not protected by §365(n) (see §12.29), this technique may be particularly helpful for a trademark licensee to utilize.

The grant of a security interest may be coupled with a liquidated damages clause setting forth the agreed amount of damages that the licensee is deemed to have suffered from a rejection or other breach of the agreement. If enforced, the liquidated damages clause will also measure the amount of the licensee's secured claim in bankruptcy. Although some courts have found that liquidated damages clauses in rejected executory contracts are not enforceable (see §12.43), that conclusion appears questionable. The principal reason for utilizing a security interest is to eliminate the debtor-licensor's motivation to reject the license agreement. The debtor should have no reason to seek rejection of the agreement if, following rejection, the licensee could assert a substantial secured claim that is entitled to be paid in full up to the value of the collateral security, thus depleting the bankruptcy estate and possibly depriving the estate of any benefit from the rejection.

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§12.57 e. Bankruptcy Remote Vehicles

Another strategy to mitigate the risks presented by a licensor's ability to reject of a license agreement is to require the licensor to establish a new legal entity to which the licensor transfers the intellectual property to be licensed in advance of the licensing transaction. The new entity then serves as an intellectual property holding company isolated from the other business activities of the licensor. The new entity may be set up as a "bankruptcy remote vehicle," with steps taken to minimize the possibility that the entity could incur substantial liabilities and thereby become insolvent or be substantively consolidated with the licensor if the licensor becomes a bankruptcy debtor. See Cieri & Morgan*, Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee's Intellectual Property and Technology Investment*, 55 Bus Law 1649, 1680 n61 (2000); Warden & McKay, Drafting Technology Licenses in a Down Market, PLI Intellectual Property Course Handbook Series No. G-801 (2004) at 299, 307. One type of bankruptcy remote vehicle sometimes used is a business trust. See Cieri & Morgan, 55 Bus Law at 1687. Bankruptcy remote vehicles may also include internal governance mechanisms that minimize the possibility of a voluntary bankruptcy filing. Establishing bankruptcy remote vehicles, however, may involve significant administrative and other costs and raise other issues that make their utility questionable except in extraordinary situations. For example, the transfer of assets and intellectual property rights to the trust may be subject to attack as a fraudulent transfer under 11 USC §§544(b) and 548. See §12.47.

Contingency arrangements that involve a software solution hosted on the vendor's computer servers are generally more difficult to implement than a source code escrow established in connection with a software license in which the licensee takes possession of the licensed software in object code form. In an arrangement involving hosted software, including any license arrangement involving an application service provider, the licensee usually does not have the infrastructure to operate the licensed software. Specially configured hardware and access to third party software, databases, and services might be required before the licensee could effectively implement the licensed software once it had possession of the code. Effective contingency arrangements might require setting up a "mirror site" that would include all of the hardware and software required to operate the software solution in the same manner as the vendor. See §12.88 for a sample trust agreement that a financially troubled vendor proposed to address customer concerns about whether the licensed software, which resided on the vendor's servers, would continue to be accessible following bankruptcy of the vendor.

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§12.58 B. Bankruptcy Filing by Licensee

Licensee bankruptcies also raise issues about which there is confusion or uncertainty—most importantly, the extent to which a debtor-licensee may assume a license agreement under Bankr C §365 without the licensor's consent. This and other issues with which a licensor must grapple following commencement of a bankruptcy case by or against the licensee are discussed in §§12.59-12.78.

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§12.59 1. Licensor's Ability to Terminate License Agreement

The first question that licensors usually face when a licensee becomes a debtor in a bankruptcy case is whether the licensor is able to terminate the license agreement based on a bankruptcy ipso facto termination clause or another termination clause in the license agreement. See generally §12.15.

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§12.60 a. Prior to Bankruptcy

If the licensor has exercised its termination rights prior to bankruptcy, it will not need to address the problems raised when the licensee under an existing license agreement becomes a debtor in a bankruptcy case. If the license agreement has been effectively terminated before commencement of the bankruptcy, nothing in the Bankruptcy Code would permit the debtor to revive the terminated agreement. See, *e.g., Emplexx Software Corp. v AGI Software (In re AGI Software, Inc.)* (Bankr D NJ 1995) 199 BR 850.

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§12.61 b. After Bankruptcy Case Commenced

After commencement of a licensee bankruptcy, however, the licensor cannot terminate the license agreement—whether under a termination-for-breach or a termination-for-convenience clause—without first obtaining relief from the automatic stay. See §12.5. See, *e.g., Computer Communications, Inc. v Codex Corp.* (*In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725 (debtor awarded substantial damages when nondebtor purported to terminate "at-will" contract with debtor without first obtaining relief from automatic stay). If the licensor is seeking to enforce a termination right arising out of the licensee's breach of the agreement, the bankruptcy court is unlikely to grant relief from stay to permit a termination if the breach is curable and the licensee has some prospect of successfully reorganizing.

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§12.62 c. Exception to Unenforceability of Ipso Facto Clauses

The general rule in bankruptcy is that the nondebtor party to an executory contract cannot enforce a bankruptcy ipso facto termination clause. See generally §12.15. Such a clause may be enforceable under Bankr C §365(e)(2) in a licensee bankruptcy, however (provided that the licensor first obtains relief from stay), if the license agreement does not permit any assignment by the licensee without the licensor's consent. See *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238.

Whether such a clause is enforceable may depend on whether the court applies the "actual test" or the "hypothetical test" (see §§12.66-12.68) that courts have adopted in construing Bankr C §365(c) and §365(e) and on the scope of any license agreement provisions that authorize the licensee to assign the agreement without consent of the licensor. If the hypothetical test is applicable (see §12.68), a bankruptcy ipso facto termination clause should be exercisable as long as the licensor has not expressly authorized the licensee to assign the license agreement in specified circumstances to an unaffiliated third party without the licensor's consent. If the licensor has consented to assignment in certain circumstances (such as a sale of all or substantially all of the licensee's assets), the ipso facto termination clause will likely be found unenforceable, consistent with the general rule of Bankr C §365(e)(1), whether or not the case is pending in a jurisdiction that applies the hypothetical test.

If the licensee's bankruptcy case is in a jurisdiction in which the hypothetical test applies and the license agreement has an absolute prohibition on assignment (thereby rendering the bankruptcy ipso facto clause enforceable under Bankr C §365(e)(2)), the licensor could argue that a clause providing for automatic termination on commencement of a bankruptcy case (*i.e.,* if no notice or other affirmative act by the licensor is required to trigger termination) is effective without the licensor first being required to obtain relief from stay. For a sample clause intended to operate in this way, see §12.83. Such an argument likely would succeed if the bankruptcy court were to find that, because the license agreement is incapable of being assumed because of the limitations in §365(c)(1), the license agreement did not constitute property of the bankruptcy estate. A bankruptcy court is probably more likely to find that the clause is not effective to terminate the agreement until the court grants relief from the automatic stay for this purpose.

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§12.63 2. Licensor's Performance Obligation Pending Assumption or Rejection

The licensor is required to continue to perform its obligations under a license agreement before the debtor-licensee assumes or rejects the agreement. As a corollary, the debtor-licensee is permitted to enforce the agreement even if it has not yet been formally assumed. See *McClean Indus., Inc. v Medical Lab. Automation, Inc.* (*In re McLean Indus., Inc.*) (Bankr SD NY 1989) 96 BR 440 (debtor in possession allowed to enforce executory option agreement before its formal assumption or rejection). Accordingly, a licensor that fails to continue to perform its obligations under a license agreement that has not been assumed or rejected does so at its peril.

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§12.64 3. Rejection of License Agreement by Debtor-Licensee

If the debtor-licensee rejects a license agreement under Bankr C §365, the licensor will have a prepetition breach of contract claim against the bankruptcy estate under Bankr C §§365(g) and 502(g). Presumably, a debtor-licensee would be motivated to reject a license agreement only if significant license fee, royalty, or other payments remained due to the licensor under the agreement. In such a situation, the licensor would not be expected to contest rejection, which should result in termination of the licensee's rights under the agreement.

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4. Assumption or Assignment of License Agreement by Debtor-Licensee

§12.65 a. Introduction

The issue in licensee bankruptcies about which there is the most confusion is whether a debtor-licensee may assume or assign intellectual property license agreements. The extent to which an intellectual property license is assumable or assignable usually depends on (1) whether the license is exclusive or nonexclusive, (2) whether and to what extent the license agreement by its terms is assignable without the licensor's consent, and (3) in the case of assumption by the licensee, whether the bankruptcy court will apply the so-called "hypothetical test" under Bankr C §365(c)(1).

Like other types of executory contracts, license agreements are generally assumable (or assumable and assignable) by a debtor- licensee under Bankr C §365 unless one of the exceptions in §365(c) applies. If an executory contract is not of a kind specified in §365(c), it may be assigned by the debtor following its assumption, notwithstanding any provision that prohibits or restricts assignment, provided that there is adequate assurance of future performance by the assignee. 11 USC §365(f)(1)-(2).

The most significant exception in §365(c) in the context of license agreements is §365(c)(1), which excludes from assignment (and also from assumption) a contract for which applicable law excuses the nondebtor party from accepting performance from, or rendering performance to, a third party. Courts in a number of cases have considered whether the reference to applicable nonbankruptcy law in §365(c)(1) is intended to refer to intellectual property law, and have uniformly found that it does. For a review of these cases, see §§12.69-12.74. As a result, certain types of intellectual property licenses are nonassignable under §365(c)(1) and (f)(2) because they are nonassignable under applicable intellectual property law without the licensor's express consent. In several federal judicial circuits, these licenses are also not assumable by the debtor under §365(c)(1).

These cases provide significant protection to a licensor of intellectual property that desires to retain complete control over the identity of the licensees of its intellectual property and whether a licensee should be permitted to exercise its license rights if it becomes a debtor in a Chapter 11 bankruptcy case. However, at least in jurisdictions in which the "hypothetical test" applies (see §12.68), these licensor protections may substantially impair a debtor's ability to successfully reorganize under Chapter 11 of the Bankruptcy Code.

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b. Legal Standards for Assumption

§12.66 (1) Generally

The application of Bankr C §365(c)(1) in the context of a debtor-licensor's assumption of an intellectual property license when no later assignment to a third party is intended is subject to conflicting results. The Third, Fourth, Ninth, and Eleventh Circuits apply what is known as the "hypothetical test," based on a literal reading of §365(c)(1). See §12.68. The hypothetical test precludes a debtor from assuming an intellectual property license if the debtor would be prohibited by applicable intellectual property law from assigning the license to a hypothetical third party—whether or not the debtor in fact intends to assign the agreement to a third party after assumption. See *RCI Technol. Corp. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257; *Perlman v Catapult Entertainment (In re Catapult Entertainment)* (9th Cir 1999) 165 F3d 747; *City of Jamestown v James Cable Partners LP* (*In re James Cable Partners)* (11th Cir 1994) 27 F3d 534, 537; *In re West Electronics Inc.* (3d Cir 1988) 852 F2d 79, 83. (It should noted that the nonassignable contracts in the *James Cable Partners* and *West Electronics* decisions were not intellectual property licenses.)

The First and Fifth Circuits apply the so-called "actual test" (see §12.67), which permits the debtor-licensee to assume an intellectual property license if the licensee is not proposing to assign the license to a third party in connection with the assumption. See *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238; *Institut Pasteur v Cambridge Biotech Corp.* (1st Cir 1997) 104 F3d 489. A majority of lower courts also apply the "actual test" rather than the "hypothetical test." See *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566, 569 n2, and cases cited. See also *In re Sunterra Corp.,* 361 F3d at 262.

Courts have struggled to reconcile the seemingly contradictory language of Bankr C §§365(c)(1) and (f)(1). On the one hand, §365(f)(1) provides that a debtor may assign an executory contract in accordance with §365(f)(2) (which requires the debtor to first assume the contract) "notwithstanding a provision in an executory contract…or in applicable law, that prohibits, restricts or conditions the assignment of such contract." 11 USC §365(f)(1). On the other hand, §365(c)(1) prohibits a debtor from assuming or assigning an executory contract if (11 USC §365(c)(1))

> applicable law excuses a party, other than the debtor, to such contract… from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract… prohibits or restricts assignment of rights or delegation of duties.

As the Sixth Circuit has observed, §365(c)(1) "appears at first to resuscitate in full the very anti-assignment 'applicable law' which §365(f) nullifies." *Rieser v Dayton Country Club Co.* (*In re Magness)* (6th Cir 1992) 972 F2d 689, 695.

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§12.67 (2) Actual Test

The Fifth Circuit's decision in *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238 is the most recent federal circuit court decision addressing whether the "hypothetical test" or the "actual test" applies. In *Mirant,* however, unlike the other circuit court decisions on this point, the issue was addressed in the context of interpreting Bankr C §365(e)(2), relating to enforcement of bankruptcy *ipso facto* clauses, rather than §365(c)(1). The Fifth Circuit ruled that the "actual test" was applicable, joining the First Circuit as the only other circuit court to adopt that test. Although the §365(e)(2) language at issue in *Mirant* differs in some respects from the relevant language of §365(c)(1), the reasoning of the Fifth Circuit in *Mirant* suggests that the result would be the same under §365(c)(1).

As noted in §§12.66 and 12.68, courts adopting the "hypothetical test" under §365(c)(1) all apply the plain meaning rule of statutory construction to reach that result. The court in *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566 also applied the plain meaning rule in its analysis of §365(c)(1), but reached the opposite conclusion that the "actual test" applied. The court based its conclusion on a finding that, despite the arguably inconsistent provisions of Bankr C §1107(a), the term "trustee" as used in §365(c)(1) does not mean "debtor in possession." See 323 BR at 571. It remains to be seen whether courts in the circuits in which there is no controlling precedent will adopt this reasoning as grounds for applying the "actual test." See also *In re Aerobox Composite Structures, LLC* (Bankr D NM 2007) 373 BR 135 (holding that "actual test" is applicable under §365(c)(1) based on reasoning of *Footstar* decision, thereby permitting debtor licensee to assume exclusive patent license); *In re Adelphia Communications Corp.* (Bankr SD NY 2007) 359 BR 65, 72 (stating that *Footstar* reasoning underlying adoption of "actual test" under §365(c)(1) was "plainly correct" in connection with holding that local cable television ordinances prohibiting assignment of cable franchise without consent of local franchise authority constituted "applicable law" for purposes of §365(c)(1)(A)).

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§12.68 (3) Hypothetical Test

The most notable case interpreting Bankr C §365(c)(1) in the context of an intellectual property license is *Perlman v Catapult Entertainment (In re Catapult Entertainment)* (9th Cir 1999) 165 F3d 747. *Catapult* involved the assumability of a patent license. Although the Ninth Circuit conceded that the debtor had marshaled considerable support for its argument that the "actual test" should apply, the Ninth Circuit nevertheless construed §365(c)(1) based on its plain meaning and concluded that the debtor was prohibited from assuming the patent license agreement at issue based on the "hypothetical test." Under this test (165 F3d at 750),

> [a] debtor in possession may not assume an executory contract over the non-debtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to such a third party.

The Fourth Circuit's decision in *RCI Technol. Corp. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257 illustrates the potential mischief that the "hypothetical test" may create under §365(c). At issue in *Sunterra* was the debtor-licensee's fully paid, irrevocable, and perpetual software license from RCI, for which the debtor had paid a $3.5 million license fee. In addition, the debtor had expended $38 million to modify the licensed software. Applying the "hypothetical test" based on a "plain meaning" interpretation of §365(c)(1), the Fourth Circuit held that the license agreement could not be assumed, notwithstanding that RCI had consented in the license agreement to an assignment of the license to a successor in interest of substantially all of the debtor's assets. The debtor was therefore compelled to forfeit its rights under the license agreement, even though (1) the debtor was not proposing to assign the agreement, (2) the licensor had unconditionally consented in the agreement to an assignment to a successor to the debtor's business, and (3) the debtor had expended millions of dollars to obtain a fully paid, perpetual license under which the executory obligations of the parties were insubstantial. The Fourth Circuit rejected the debtor's argument that a literal interpretation of §365(c)(1) would be inconsistent with the bankruptcy policy of fostering a successful reorganization and maximizing the value of the debtor's assets.

NOTE: It seems questionable whether Congress intended that §365(c)(1) be construed so as to preclude a licensee from assuming a license agreement as a debtor-in-possession if the licensee, outside of bankruptcy, would be free to assign the license agreement to any third party that succeeded to substantially all of the licensee's assets. The cases applying the "hypothetical test" have construed the relevant Bankruptcy Code provisions in a manner consistent with their literal language. Application of this test, however, jeopardizes the ability of a debtor whose business depends on continuing access to intellectual property licensed from third parties to reorganize successfully. Nothing in the relevant legislative history suggests that Congress intended to create artificial limitations on a debtor-licensee's rights to retain the benefits conferred on it under prebankruptcy license agreements.

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§12.69 c. Assignability of Intellectual Property Licenses

If a debtor-licensee is seeking to assume (but not assign) an intellectual property license agreement and the bankruptcy court applies the "hypothetical test" (see §§12.66, 12.68), or if the licensee is seeking to assign the agreement, the bankruptcy court must make two determinations: (1) under Bankr C §365(c)(1), whether the license agreement cannot be assigned without the licensor's express consent under applicable intellectual property law; and (2) if so, whether the requisite consent is contained in the terms of the license agreement.

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(1) Patent Licenses

§12.70 (a) Nonexclusive Patent Licenses

In several cases, courts construing Bankr C §365 and federal patent law have found that patent licenses cannot be assumed or assigned by a debtor-licensee under §365 without the licensor's consent. In *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673, 679, the Ninth Circuit Court held that, as a matter of federal common law, a nonexclusive patent license could not be assigned without consent of the licensor, notwithstanding the general assignability of executory contracts in bankruptcy proceedings. The court stated that "[i]t has long been held by federal courts that agreements granting patent licenses are personal in nature and not assignable unless expressly made so." 89 F3d at 679. See also *PPG Indus., Inc. v Guardian Indus. Corp.* (6th Cir) 597 F2d 1090, 1093, cert denied (1979) 444 US 930; *In re Access Beyond Technols., Inc.* (Bankr D Del 1999) 237 BR 32; *In re Alltech Plastics* (WD Tenn 1987) 71 BR 686.

The logic of the *Everex* case was taken a step further by the Ninth Circuit in *Perlman v Catapult Entertainment (In re Catapult Entertainment)* (9th Cir 1999) 165 F3d 747 (see §12.68). In that case, the court held that, under §365(c)(1), a Chapter 11 debtor-licensee could not assume its patent license because federal patent law treats nonexclusive patent licenses as personal and nondelegable and the patent licensor had not consented to an assumption or assignment. 165 F3d at 750.

Applying the "actual test" under §365(c)(1) (see §§12.66-12.67), the First Circuit in *Institut Pasteur v Cambridge Biotech Corp.* (1st Cir 1997) 104 F3d 489 held that a nonexclusive patent license agreement could be assumed by the debtor-licensee without the licensor's consent under a plan of reorganization that effected a change of control of the debtor. The license agreement had a provision limiting assignment but did not include a "change of control" clause that would have triggered a default on a change of control of the debtor or that would treat a change of control as an assignment for which the licensor's consent would be required. Under the circumstances, the First Circuit found no assignment had taken place, construing §365(c)(1) as not applicable in an assumption that did not also involve an assignment of the agreement to a third party. Thus, if the licensor had negotiated a clause providing that a change of control constituted an assignment for which the licensor's consent was required, the court would have reached a different result.

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§12.71 (b) Exclusive Patent Licenses

In *In re Hernandez* (Bankr D Ariz 2002) 285 BR 435, the bankruptcy court considered the application of Bankr C §365(c)(1) to an exclusive patent license agreement. The court held that the nonassignability rule of *Perlman v Catapult Entertainment (In re Catapult Entertainment)* (9th Cir 1999) 165 F3d 747 regarding nonexclusive patent licenses applied equally to exclusive licenses. See also *Proteotech, Inc. v Unicity Int'l, Inc.* (WD Wash 2008) 542 F Supp 2d 1216 (citing *Hernandez*, holding that licensee may not grant sublicense under exclusive patent license without consent of licensor or express authorization in license agreement); *Murray v Franke-Misal Technols. Group, LLC (In re Supernatural Foods, LLC)* (Bankr MD La 2001) 268 BR 759 (assuming that an exclusive patent license is unassignable under §365(c)(1) and (f)(2) in absence of express consent of licensor, but finding that license agreement embodied such consent). But see *In re Access Beyond Technols., Inc.* (Bankr D Del 1999) 237 BR 32 (suggesting in dicta that, although nonexclusive patent licenses are not assignable without licensor's consent, result may differ in cases involving exclusive patent licenses); *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404 (finding that California law, rather than federal common law, applied to issue of assignability of exclusive patent license and that exclusive license was assignable when there was no prohibition on assignment or other provision in the license agreement addressing assignability).

NOTE: Given the relative dearth of case law regarding the ability of a licensee to assign an exclusive patent license without consent of the licensor, the application of §365(c)(1) and (f)(2) to exclusive patent licenses remains uncertain.

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§12.72 (2) Copyright Licenses

The limited number of cases that have addressed the application of Bankr C §365(c)(1) to copyright licenses have found that, under federal copyright law and §365(c)(1), nonexclusive copyright licenses cannot be assumed and assigned in bankruptcy proceedings without consent of the licensor. For example, the court in *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237 held that a Chapter 11 debtor-licensee could not assign a nonexclusive license of copyrighted photographs, finding that the general rule of assignability under §365 must give way to the countervailing federal policy designed to protect the monopoly of copyright owners. See also *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300. The assignability of copyright licenses in bankruptcy proceedings also was addressed in *Harris v Emus Records Corp.* (9th Cir 1984) 734 F2d 1329, a Ninth Circuit case decided under the Bankruptcy Act of 1898. In *Harris,* the court held that a mechanical recording license could not be assigned without the licensor's consent because the license rights were personal in nature.

There is conflicting authority regarding whether exclusive copyright licenses are nonassignable (and potentially nonassumable) under §365(c)(1). In *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774, 780, the Ninth Circuit found (in a nonbankruptcy case) that an exclusive copyright license relating to a cartoon character could not be assigned without the licensor's consent. Therefore, exclusive copyright licenses of a licensee in a bankruptcy case filed in California or elsewhere in the Ninth Circuit are not assumable under §365(c)(1) in the absence of an express consent to assignment or another clause in the license agreement that is construed to be a waiver of the licensor's right to consent to any assumption or assignment of the exclusive copyright license. See also *Cadsoft Corp. v Riverdeep, LLC* (ND Cal 2007) 2007 US Dist Lexis 39559 (express consent required to assign software development and publishing agreement under which exclusive license was granted).

Outside the Ninth Circuit, the treatment of exclusive copyright licenses under §365(c)(1) is uncertain. In *In re Golden Books Family Entertainment, Inc., supra,* the bankruptcy court held that an exclusive copyright license of a children's cartoon character could be assumed and assigned, finding that §365(c)(1) applied only to nonexclusive copyright licenses. See also *In re Patient Educ. Media, Inc., supra,* stating, in dicta, that exclusive copyright licenses are a form of copyright ownership and are freely assignable. *Patient Educ. Media, Inc.,* 210 BR at 240. Because an exclusive copyright license is treated as a transfer of ownership under federal copyright law (see 17 USC §201), it seems likely that courts outside the Ninth Circuit are more likely to follow the result reached in the *Golden Books* case and hold exclusive copyright licenses to be assignable by a debtor-licensee, despite any prohibition on assignment in the license agreement.

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§12.73 (3) Trademark Licenses

The courts' application of Bankr C §365(c)(1) to trademark licenses has been inconsistent. Earlier cases held that federal trademark law did not excuse a trademark licensor from accepting performance from a third party and that §365(c)(1) and (f)(2) did not bar assignment of a trademark license in the absence of the licensor's consent. See, *e.g., In re Superior Toy & Mfg. Co., Inc.* (7th Cir 1996) 78 F3d 1169, 1176; *In re Rooster* (Bankr ED Pa 1989) 100 BR 228, 229. More recent cases have reached the opposite result, finding that trademark licenses are subject to §365(c)(1) and are therefore nonassignable (and possibly also nonassumable) without the licensor's consent. In *N.C.P. Mktg. Group, Inc. v Blanks* (*In re N.C.P. Mktg. Group, Inc.)* (D Nev 2005) 337 BR 230, aff'd (9th Cir 2008) 279 Fed Appx 571, the court found that a trademark owner "has an interest in the party to whom the trademark is assigned so that it can maintain the good will, quality, and value of its products and thereby its trademark." The court ruled that trademark rights are personal and not subject to assignment without consent of the licensor. 337 BR at 236. See also *Wellington Vision, Inc. v Perle Vision, Inc. (In re Wellington Vision, Inc.)* (SD Fla 2007) 364 BR 129 (affirming bankruptcy court holding that nonexclusive trademark license was incapable of assumption because of §365(c)(1)); *In re Travelot Co.* (Bankr SD Ga 2002) 286 BR 447, 455 (stating nonexclusive trademark license could not be assumed without licensor's consent, but finding contract to be assumable because contract did not grant trademark license to debtor). See generally McCarthy, McCarthy on Trademarks and Unfair Competition §25.33 (4th ed 1992) ("while the case law is sparse, it appears to be the rule that unless the license states otherwise, a license mark is personal and cannot be assigned").

The treatment of exclusive trademark licenses under §365(c)(1) and (f)(2) is uncertain. Although there is some precedent for treating exclusive trademark licenses as personal to the licensor and nonassignable without the licensor's consent (see *Tap Publications, Inc., v Chinese Yellow Pages (NY), Inc.* (SD NY 1996) 925 F Supp 212, 218), there appears to be no uniform rule. In *In re Global Home Prods., LLC* (D Del 2007) 369 BR 770, the district court considered an appeal from a bankruptcy court decision holding that an exclusive trademark license agreement could be assigned by the debtor licensee without the licensor's consent, finding that §365(c)(1) and (f)(2) did not bar the licensee from assigning the license agreement without the licensee's consent. (The federal district court dismissed the trademark licensor's appeal as moot.) Accordingly, although the result is uncertain, it appears that exclusive trademark licenses should be assignable without the express consent of the licensor, consistent with the result reached in the *Golden Books* case under copyright law, and therefore assignable by the licensee under §365(f)(2) notwithstanding any provision in the license agreement that limits or restricts assignment.

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§12.74 (4) Trade Secret Licenses

Apparently, no published case has considered whether Bankr C §365(c)(1) applies to a trade secret license, thereby rendering it nonassumable. One court has suggested in a different context that a trade secret license may be unassignable without consent of the licensor and thus could be subject to §365(c)(1) in a bankruptcy of the licensee. In *Verson Corp. v Verson Int'l Group PLC* (ND Ill 1995) 899 F Supp 358, a licensor brought a breach of contract action against the licensee based on the licensee's purported assignment of know-how to a third party under a terminated license agreement covering both patent and trade secret rights. No provision in the license agreement authorized the licensee to assign the licensed know-how. Although the breach in question involved a purported transfer of know-how only, and not of any of the licensed patent rights, the court's discussion of whether the licensor's consent was required to assign the know-how relied solely on case law relating to the assignability of patent licenses. The court nowhere acknowledged that those cases do not address the assignability of know-how or other trade secrets. Based on the *Verson* case, a trade secret licensor has an argument that §365(c)(1) also should apply to a license agreement covering know-how or other trade secrets. It seems more likely, however, that a bankruptcy court would find that §365(c)(1) does not apply to trade secret licenses, given the very limited case authority under §365(c)(1).

NOTE: A license agreement under which know-how and other trade secrets are licensed will usually also cover copyrights or patent rights relating to the subject technology, thus making the license agreement subject to §365(c)(1) in any event.

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§12.75 d. Possibility of "Ride-Through"

The extent to which courts will go to avoid the seeming inequity of the *Catapult* rule (see §12.70) is demonstrated by *In re Hernandez* (Bankr D Ariz 2002) 287 BR 795, where the court denied a motion to compel rejection of a license agreement after having earlier ruled that the license agreement, under which an exclusive patent license was granted, was nonassumable under §365(c)(1). See §12.71. The *Hernandez* court noted that, if it were to compel the licensee to reject the agreement, the licensee would be forfeiting its rights simply by virtue of becoming a debtor in a bankruptcy case and without regard to whether any breach had occurred. The court reviewed the history and scope of the "ride-through" doctrine, by which a contract that is neither rejected nor assumed before confirmation of a plan of reorganization is unaffected by the bankruptcy case. See, *e.g., Stumpf v McGee (In re O'Connor)* (5th Cir 2001) 258 F3d 392. The *Hernandez* court found it to be "a well recognized and established legal doctrine" that should apply when an executory contract is not assumable under §365(c)(1), even if the other party has objected to such treatment. 287 BR at 800. The court conceded that none of the published cases involving the ride-through doctrine involved a timely objection by the nondebtor party to an attempt by the debtor to allow the contract to ride through a Chapter 11 case. The court did, however, grant the licensor's request for relief from the automatic stay to allow it to exercise whatever termination rights it had under applicable nonbankruptcy law. See also *Diamond Z Trailer, Inc. v JZ LLC (In re JZ LLC*) (BAP 9th Cir 2007) 371 BR 412 (manufacturing technology license that was neither assumed nor rejected during licensor's Chapter 11 case found to be enforceable by licensor following confirmation of licensor's Chapter 11 plan, based on "ride through" doctrine).

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§12.76 e. Effect of Consent-to-Assignment Provision

The cases in which courts have found intellectual property licenses to be nonassumable or nonassignable have usually involved license agreements with a flat prohibition on assignment by the licensee. In these cases, apart from the issue of whether the "hypothetical test" or the "actual test" applies under Bankr C §365(c)(1) (see §§12.66-12.68), application of the general rule that an intellectual property license cannot be assigned without the licensor's affirmative consent is relatively straightforward. If, however, the license agreement contains a provision in which the licensor consents to assignment of the agreement by the licensee in specified circumstances, application of this rule is not straightforward and yields conflicting results.

If a license agreement, by its express terms, is freely assignable without limitation, nothing in §365(c)(1) should operate, in conjunction with the relevant intellectual property law, to impose a limitation on assignment (and assumption if the "hypothetical test" is applicable) under §365(c)(1). Section 365(c)(1) should operate to permit any assignment of a license agreement by the debtor in bankruptcy that is permitted outside of bankruptcy. For example, if a license agreement is assignable by a licensee in connection with a sale of substantially all of the assets (without need for further consent by the licensor), such an assignment should also be permitted in a bankruptcy context.

Several cases have considered the effect of a consent-to-assignment clause on the assumability of a license agreement under §365(c)(1). In the first *Hernandez* decision, the court construed the effect of a clause permitting an assignment to a corporation in which the licensee held an interest of at least 51 percent. *In re Hernandez* (Bankr D Ariz 2002) 285 BR 435, 441. Noting that the "hypothetical test" applied, the court indicated that assumption would be permitted only if the licensor had consented to an assignment in a manner that would render §365(c)(1) inapplicable. The court discussed the effect of a consent-to-assignment clause as follows (285 BR at 441):

> In consenting to assignment in such situations, the non-debtor parties to the contracts gave up any interest in the identity of the assignees, thereby effectively removing the contracts from the protections otherwise afforded to them under "applicable law" and §365(c)(1), to control the identity of assignees.

The court found, however, that a consent to assign the license agreement to a controlled affiliate did not render §365(c)(1) inapplicable, observing as follows (285 BR at 441):

> Transferring ownership of the License from [the licensee] to an entity which he controls is merely a change in form, not identity. In order to prevail under the hypothetical test, the Debtors must be able to demonstrate that federal patent law would require the Licensor to accept performance from, and render performance to, a party different from [the licensee]. [Citations.] The Debtors cannot meet the hypothetical test because a Hernandez controlled entity is not different from [the licensee].

In *Wellington Vision, Inc. v Perle Vision, Inc. (In re Wellington Vision, Inc.)* (SD Fla 2007) 364 BR 129, the debtor-licensee argued that the licensor "opted out" of application of §365(c)(1) to its assumption of a trademark license because the agreement provided that the licensor could not unreasonably withhold its consent to an assignment by the debtor-licensee. The court found that the agreement not to withhold consent unreasonably was not tantamount to a consent to assignment that would render inapplicable the limitations of §365(c)(1). But see *In re Aerobox Composite Structures, LLC* (Bankr D NM 2007) 373 BR 135 (noting in dicta that attempt by licensor to invoke limitations on assumption and assignment under §365(c)(1) was inconsistent with licensor's agreement not to unreasonably withhold its consent to assignment).

The court in *In re Quantegy* (Bankr MD Ala 2005) 326 BR 467 found that a provision in the license agreement that permitted the licensee to assign the license agreement to wholly-owned subsidiaries, sister divisions, and parent companies constituted a consent by the licensor to be bound to a third party assignee that rendered §365(c)(1) inapplicable to the debtor-licensee's assumption.

In *Murray v Franke-Misal Technols. Group, LLC (In re Supernatural Foods, LLC)* (Bankr MD La 2001) 268 BR 759, the court considered the effect of a consent to assignment in an exclusive patent license in a Chapter 7 case. The clause in question authorized the debtor-licensee to assign the patent license "incident to the sale of the substantial portion of [the debtor]'s assets." 268 BR at 804. The court concluded that this language constituted an effective

prebankruptcy consent by the licensor that authorized the trustee to assume and assign the patent license agreement, notwithstanding §365(c)(1).

The foregoing cases suggest a simple rule that, if a licensor has consented to the assignment of the license agreement to a third party, whether unconditionally or only in specified circumstances, the debtor is not barred from assuming the license agreement under §365(c)(1). This rule has not been uniformly applied, however. In *RCI Technol. Corp. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257, the Fourth Circuit reached the anomalous result that, even though the software license agreement at issue permitted the licensee to assign it to a successor in interest that acquired substantially all of the licensee's assets, the licensee was precluded from assuming the agreement by §365(c)(1). See §12.68. The Fourth Circuit reasoned that the consent to assignment did not operate to render the license agreement assumable because the consent clause made no reference to assumption of the agreement. Accordingly, in a case in the Fourth Circuit involving application of §365(c)(1), even if a license agreement by its terms is freely assignable by the licensee, the license agreement apparently cannot be assumed by the debtor if the agreement does not also include language that expressly authorizes the licensee to assume the agreement under Bankr C §365.

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§12.77 5. Postrejection Enforcement of Confidentiality Obligations

One area of special concern to a licensor in the context of a licensee's rejection of a license agreement covering technology protected as a trade secret is the extent to which the licensor will be able to continue to enforce the licensee's confidentiality obligations following rejection of the agreement. One specific remedy available to a licensor in this context is Bankr C §107(b)(1), which requires the bankruptcy court, on request of a party in interest, to "protect an entity with respect to a trade secret or confidential research, development or commercial information." No "good cause" or other showing is required to invoke this protection, although it implicitly requires the party requesting relief to identify the information claimed to be confidential—which may be difficult if no log of the confidential information has been kept and if the documents given to the debtor did not have confidentiality markings.

In one commentator's view, rejection of a license agreement should not preclude the licensor from enforcing a confidentiality provision under applicable nonbankruptcy law, if the provision states that it will survive termination of the license agreement. Epstein & Politano, Drafting License Agreements ¶6.02[D][1] (4th ed 2002). See also Shulman & Blumberg, *Protection of Licensing Rights for Technology Companies in US Bankruptcy Cases*, Financier Worldwide (June 2006) (following rejection of a license agreement, debtor-licensor remains bound by passive obligations such as duty to maintain confidentiality). There appear to be no published cases in which the beneficiary of a confidentiality provision under a rejected executory contract (or an executed contract not subject to Bankr C §365) has been permitted to enforce the provision. It appears uncertain whether the nondebtor party to a rejected license agreement having a confidentiality clause that is stated to survive termination of the agreement will be permitted to enforce the clause following rejection. In the absence of any case authority supporting this position, a party desiring to enforce a confidentiality clause should consider requesting relief from the bankruptcy court under Bankr C §107(b)(1).

NOTE: Interestingly, the views of the General Counsel of the Department of Commerce regarding the enactment of Bankr C §365(n) that are included in the Senate report (S Rep No. 100-505, 100th Cong, 2d Sess (1988), reprinted at 1988 US Code Cong & Ad News 3200) reflect a concern about the effect of rejection of an executory contract on confidentiality obligations in the contract. Specifically, these views suggest that the legislative history should reflect that termination of a rejected contract does not result in the termination of continuing obligations as confidentiality and protection of trade secret information, noting that, without such clarification, a "trustee may fear that rejecting an executory contract involving a trade secret would jeopardize the trade secret." S Rep No. 101-505 at 13, 1988 USCCAN at 3210. The Senate report separately observes, however, that the bill adopting §365(n) "does not treat certain issues related to intellectual property that are already dealt with elsewhere in the Code: Maintaining the confidentiality of trade secrets is adequately provided for in §107(b)(2)." S Rep No. 101-505 at 6, 1988 USCCAN at 3204. Accordingly, the legislative history indicates that Congress assumed that Bankr C §107(b)(2) provides an appropriate means for protection of trade secrets, irrespective of the status of the confidentiality obligations of a party to a license agreement following its rejection.

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§12.78 6. Prebankruptcy License Payments as Avoidable Preferences

One final issue that may confront a licensor whose licensee becomes a debtor in a bankruptcy case concerns the possibility that the licensor may be required to disgorge payments received from the licensee shortly before bankruptcy. If a licensee commences a bankruptcy case within 90 days after making a payment to a licensor, the licensor may find itself subject to a claim that it received an avoidable preference under Bankr C §547(b) that must be returned to the bankruptcy estate. It should be noted that the grant of a security interest (or any other transfer of property) may also constitute an avoidable preference under §547(b). Under §547(b), the debtor may recover any transfer made by the debtor: (1) to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) while the debtor was insolvent—with the debtor presumed to have been insolvent for 90 days before the petition date; (4) on or within 90 days of the petition date (or, if made to an insider, including an officer, director, partner, subsidiary, affiliate, or "controlling person," between 90 days and 1 year before the petition date); and (5) as a result of which the creditor received more than it would have received as a general claimant in a Chapter 7 liquidation. 11 USC §547(b).

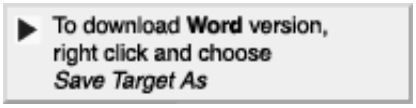
It should also be noted that certain payments or other transfers made by the debtor are not recoverable as preferences. Importantly, in the context of a license agreement, the following transfers are not avoidable preferences: (1) a transfer intended to be a contemporaneous exchange for new value given to the debtor and which is a substantially contemporaneous exchange, and (2) the payment of a debt incurred in the ordinary course of business of the debtor and the creditor if either the payment was made in the ordinary course of business of the debtor and the creditor or it was made according to ordinary business terms (as measured by industry standards). 11 USC §547(c)(1)-(2). Regular periodic royalty payments that are timely made by a licensee under a royalty-bearing license ought to be protected by the ordinary course exception under §547(c)(2), but license fees, if large enough or if not paid in accordance with the terms of the license agreement, would not necessarily be protected by this exception. Whether a payment qualifies for the §547(c) exception becomes an issue only if the license agreement is not assumed by the licensee under Bankr C §365, because assumption requires the licensee to bring current all payment obligations owing to the licensor.

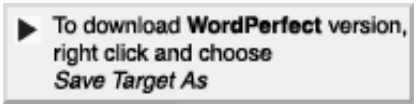
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IV. BANKRUPTCY-RELATED PROVISIONS FOR LICENSES AND RELATED AGREEMENTS

A. Provisions Applicable in Licensor Bankruptcy

§12.79 1. Form: Clause Acknowledging Applicability of §365(n)





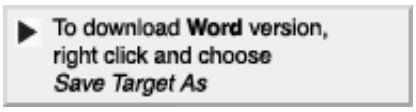
12.79-1 Clause acknowledging applicability of §365(n)

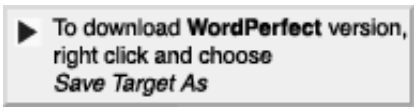
NATURE OF LICENSEE'S RIGHTS. All rights and licenses granted under or pursuant to this Agreement by Licensor to Licensee are, and shall be deemed to be, for purposes of Bankruptcy Code §365(n), licenses of rights to "intellectual property" as defined under Bankruptcy Code §101(35A) (the "Intellectual Property"). The parties agree that Licensee, as a licensee of the Intellectual Property under this Agreement, shall retain and may fully exercise all of its rights and elections under the Bankruptcy Code in the event a case is commenced by or against Licensor under the Bankruptcy Code and Licensor rejects this Agreement pursuant to Bankruptcy Code §365, including the right of Licensee to elect under Bankruptcy Code §365(n)(1)(B) to retain all of the its rights and licenses granted by Licensor that are in existence immediately before the commencement of such case, including without limitation any rights granted to Licensee with respect to any patents that issue on any patent applications pending at the time of commencement of such case or any then-existing rights with respect to patents issued, or works of authorship protected, under the law of any foreign jurisdiction.

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Source: Business Law/Intellectual Property in Business Transactions/12 Intellectual Property Licenses in Bankruptcy/ §12.80 2. Form: Clause Acknowledging Applicability of §365(n) in Bundled License

§12.80 2. Form: Clause Acknowledging Applicability of §365(n) in Bundled License



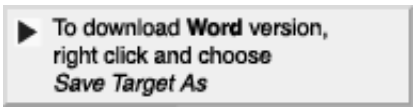


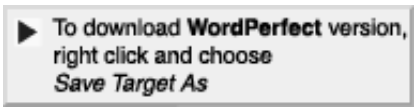
12.80-1 Clause acknowledging applicability of §365(n) in bundled license

INTEGRAL NATURE OF TRADEMARK RIGHTS. The parties agree that the trademark rights included in the intellectual property rights licensed hereunder are an essential and integral component of the intellectual property rights granted to Licensee under this Agreement, without which Licensee would not have entered into this Agreement and cannot realize the benefits intended to be conferred on Licensee by this Agreement. Accordingly, the parties agree that such trademark rights form part of a bundle of nonseverable intellectual property rights that, for purposes of Bankruptcy Code §365(n), shall be deemed to constitute "intellectual property" as defined in Bankruptcy Code §101(35A) as to which the Licensee shall have all of the rights and elections provided for under Bankruptcy Code §365(n) in the event a case is commenced by or against Licensor under the Bankruptcy Code and Licensor rejects this Agreement pursuant to Bankruptcy Code §365.

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§12.81 3. Form: Clause Allocating Fees



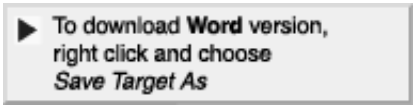


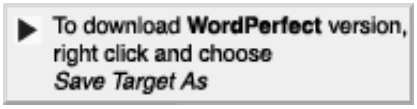
12.81-1 Clause allocating fees

FEES. The parties agree that _ _[*percent*]_ _ of the Recurring Fees (the "License Portion" of the Recurring Fees) represents payments from Licensee to Licensor in consideration for the license rights to the Intellectual Property granted to Licensee under this Agreement, and _ _[*percent*]_ _ of the Recurring Fees (the "Services Portion" of the Recurring Fees) represents consideration for Licensor's performance of all its affirmative obligations under this Agreement, including, but not limited to, its maintenance, support, training, and other obligations under Sections _ _[*numbers*]_ _ of this Agreement (the "Licensor Affirmative Obligations"). To the extent that Licensor fails to perform the Licensor Affirmative Obligations, the Recurring Fees to which Licensor shall be entitled shall be limited to the License Portion of the Recurring Fees and the Services Portion of the Recurring Fees that are in consideration of the performance of the Licensor Affirmative Obligations thereafter shall no longer be payable by Licensee under this Agreement. The rejection of this Agreement by Licensor or its bankruptcy trustee pursuant to Bankruptcy Code §365 shall be deemed conclusively to constitute Licensor's failure to perform all of its Licensor Affirmative Obligations, thereby discharging Licensee from any obligation to pay the Services Portion of the Recurring Fees.

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§12.82 4. Form: Clause Conditioning Licensor's Assumption and Assignment Rights





12.82-1 Clause conditioning licensor's assumption and assignment rights

ASSIGNMENT IN BANKRUPTCY PROCEEDINGS. In the event of commencement of a case under the Bankruptcy Code by or against Licensor, and Licensor or its bankruptcy trustee attempts to assume or assign this Agreement pursuant to Bankruptcy Code §365, for purposes of Bankruptcy Code §365(b)(1) and (f)(2)(b), the parties agree that adequate assurance of future performance under this Agreement includes (i) the affirmative assumption by Licensor or its proposed assignee of all of Licensor's obligations under this Agreement and (ii) evidence reasonably acceptable to Licensee that the financial condition and operating performance of Licensor (in the event of a proposed assumption without an assignment) or the proposed assignee (in the event of a proposed assignment following assumption) is comparable to or better than the financial condition and operating performance of Licensor as of the date of this Agreement, thereby ensuring that the service and other obligations originally bargained for by Licensee can be fulfilled in all respects following assumption and, if applicable, assignment of this Agreement.

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B. Provisions Applicable in Licensee Bankruptcy

§12.83 1. Form: Clause Prohibiting Assumption and Assignment by Patent Licensee and Terminating License on Bankruptcy

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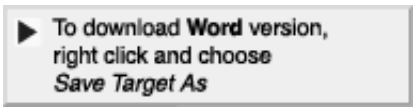
12.83-1 Clause prohibiting assumption and assignment by patent licensee and terminating license on bankruptcy

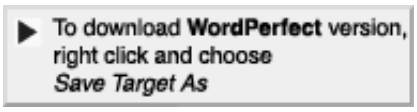
EFFECT OF BANKRUPTCY PROCEEDINGS. If for any reason Licensee becomes a debtor in a bankruptcy case, Licensee agrees that, pursuant to Bankruptcy Code §365(c)(1), this Agreement is not, and shall not be, assumable under Bankruptcy Code §365, it being agreed and acknowledged that applicable patent law would excuse Licensor from accepting performance from or rendering performance to any entity other than Licensee, whether or not this Agreement prohibited or restricted assignment of rights or delegation of duties. Therefore, pursuant to Bankruptcy Code §365(e)(2), this Agreement shall automatically terminate if and when Licensee becomes a debtor in a bankruptcy case, notwithstanding the provisions of Bankruptcy Code §365(e)(1).

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Source: Business Law/Intellectual Property in Business Transactions/12 Intellectual Property Licenses in Bankruptcy/ §12.84 2. Form: Clause Permitting Assumption by Licensee

§12.84 2. Form: Clause Permitting Assumption by Licensee





12.84-1 Clause permitting assumption by licensee

EFFECT OF BANKRUPTCY PROCEEDINGS. Licensor agrees that, notwithstanding (i) the limitations expressed herein on Licensee's right to assign this Agreement and (ii) the provisions of Bankruptcy Code §365(c)(1), if for any reason Licensee becomes a debtor in a bankruptcy case, this Agreement shall be assumable by the Licensee as debtor-in-possession under Bankruptcy Code §365, it being agreed and acknowledged that, pursuant to Bankruptcy Code §365(c)(1), this Agreement shall not be assignable by the Licensee as debtor-in-possession or by Licensee's bankruptcy trustee under Bankruptcy Code §365(f) except as expressly permitted by Licensor.

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§12.85 3. Form: Ipso Facto Termination Clause for Patent Cross-License

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12.85-1 Form: Ipso facto termination clause for patent cross-license

(a) The parties acknowledge that this Agreement (1) is personal to each of the Parties and that United States patent law excuses a Party, without its consent, from accepting performance from or rendering performance to anyone other than the other Party, and (2) constitutes an executory contract of the kind specified in Bankruptcy Code §365(c)(1). Accordingly, the Parties acknowledge and agree that Bankruptcy Code §365(e)(1) does not apply, and Bankruptcy Code §365(e)(2) does apply, to any termination of this Agreement or any of the rights and licenses granted under this Agreement, under the terms of this Agreement by reason of the commencement of a case under the Bankruptcy Code by or against a Party. The rights and licenses granted to a Party (the "Licensee Party") under this Agreement shall immediately terminate without any further action by the other Party on the occurrence of any of the following events:

(i) The Licensee Party files a petition under the Bankruptcy Code;

(ii) An involuntary petition is filed against the Licensee Party under the Bankruptcy Code, or the Licensee Party consents or acquiesces to any such filing against the Licensee Party, provided that, if the Licensee Party does not consent to such petition, only if such petition has not been discharged, stayed, or dismissed within 60 days of its filing;

(iii) The rendering of any adjudication that the Licensee Party is bankrupt or insolvent;

(iv) The Licensee Party files any petition or answer seeking or consenting to any reorganization, readjustment, or arrangement of its business under any law relating to bankruptcy or insolvency;

(v) The making by the Licensee Party of any assignment for the benefit of creditors; or

(vi) The failure by the Licensee Party to generally pay its debts as they become due or the admission by the Licensee Party in writing that it is insolvent.

(b) Additionally, a Party may terminate this Agreement, or the rights and licenses of the other Party under this Agreement, on written notice to the other Party given at any time on or after:

(1) The appointment of a receiver, supervisor, or liquidator for all or substantially all of the property of the other Party or a money judgment against the other Party that remains unsatisfied for more than 30 days after entry of judgment and such judgment has not been appealed;

(2) The institution of any proceedings for the liquidation or winding up of the business of the other Party or for the termination of its corporate charter; or

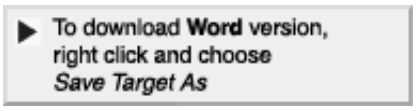
(3) The other Party undergoes a Change of Control.

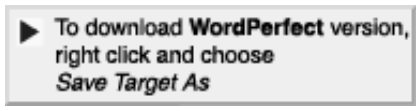
Comment: Although the above clause provides for an automatic termination on commencement of a bankruptcy case, the automatic stay under Bankr C §362 may prevent the termination from taking effect unless a bankruptcy court order granting relief from the automatic stay is obtained.

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C. Provisions Relating to Source Code Escrows

§12.86 1. Form: License Agreement Provisions





12.86-1 License agreement provisions

_ _[*Section number*]_ _ **ESCROW AGREEMENT; LICENSE GRANT (SOURCE CODE)**

(a) Within 10 business days after the date hereof, the parties shall enter into a source code escrow agreement (the "Escrow Agreement") with an escrow agent (the "Escrow Agent") selected by Licensee and approved by Licensor, which approval shall not be unreasonably withheld or delayed, pursuant to which the source code of the Software (including any Updates or New Releases provided to Licensee under this Agreement) and the names and contact information of every employee or contractor of Licensor that materially contributed to the development of the Software or any modifications made to the Software shall be deposited with the Escrow Agent pending release to Licensee on the occurrence of a Release Condition (as defined below).

(b) The parties agree that the Escrow Agreement will provide that the Escrow Agent shall release to Licensee the source code and other information deposited thereunder within 5 business days after receipt of a written notice from Licensee that a Release Condition has occurred and irrespective of whether Licensor provides the Escrow Agent with any contrary instructions or an objection thereto; provided that (1) Licensee agrees that it will not provide the Escrow Agent with a notice instructing the Escrow Agent to release such source code and other information from the escrow created under the Escrow Agreement unless Licensee in good faith determines that a Release Condition has occurred thereunder, and (2) the parties agree that (A) the amount of damages that Licensor would suffer if Licensee were to trigger a source code release under the Escrow Agreement in the absence of the occurrence of an actual Release Condition would be difficult to ascertain, and (B) Licensee shall pay to Licensor, as liquidated damages and not as a penalty, the sum of $_ _[*amount*]_ _ if it is judicially determined pursuant to a final order or judgment that Licensee wrongfully triggered a release of such source code and other information pursuant to its notice to the Escrow Agent.

(c) Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee a nonexclusive, worldwide, royalty-free, nonassignable, nontransferable license to use, copy, execute, prepare derivative works, adapt, customize, enhance, and otherwise modify the source code of the Software that is released to Licensee pursuant to the Escrow Agreement for the sole purposes of maintaining, supporting, and enhancing the Software, it being agreed that (1) no such source code shall be delivered to Licensee until occurrence of a Release Condition pursuant to the terms of the Escrow Agreement and (2) the exercise by Licensee of any of the rights with respect to source code granted in this Agreement before the occurrence of a Release Condition would constitute a breach by Licensee of its obligations under this Agreement. Licensee may grant sublicenses under the source code license granted herein to a third party; provided that such third party agrees in writing to: (A) abide by the terms of this Agreement; (B) not provide such source code or any part thereof to any third party; (C) use such source code solely for the purposes of providing services to Licensee; and (D) destroy such source code on the completion of its services for Licensee.

(d) A "Release Condition" shall occur under the Escrow Agreement on the happening of any of the following events:

(1) The commencement of a voluntary bankruptcy case by Licensor, the entry of an order for relief in an involuntary bankruptcy case against Licensor, or the commencement of an involuntary bankruptcy case against Licensor that remains undismissed 45 days after the filing of the involuntary petition;

(2) Licensor makes a general assignment for the benefit of its creditors;

(3) A receiver, trustee, custodian, or similar officer is appointed for or over Licensor or any of its property;

(4) The employment of all or a substantial part of Licensor's technical support team shall have terminated for any reason;

(5) A Change of Control of Licensor shall have occurred that involves a competitor of Licensee;

(6) Licensor shall have dissolved or ceased to do business in the normal course; or

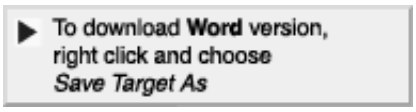
(7) Licensor's material breach of its support obligations hereunder that is not cured within 30 days after delivery of written notice of such breach by Licensee to Licensor.

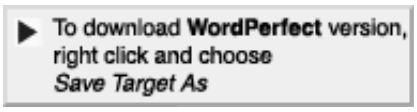
(e) If a Release Condition occurs and if, for any reason, the source code of the Software deposited by the Licensor pursuant to the Escrow Agreement is not promptly released to the Licensee, or if the source code of the Software that is released to Licensee pursuant to the Escrow Agreement following the occurrence of a Release Condition is not the then-current version of the Software being used by Licensee, Licensor agrees, promptly on receipt of a written request therefor, to deliver directly to Licensee a complete copy of such source code.

(f) Licensor agrees and acknowledges that nothing in this Agreement limits the right of Licensee to solicit, hire, or engage any employees or contractors of Licensor following the occurrence of a Release Condition.

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§12.87 2. Form: Escrow Agreement Clauses





12.87-1 Escrow agreement clauses

TITLE TO TANGIBLE MEDIA. The Escrow Agent shall have title to all tangible media embodying or incorporating any of the Escrowed Materials deposited by Depositor with the Escrow Agent (and Depositor hereby assigns to the Escrow Agent title to such tangible media), and Depositor shall have no right, title, or interest therein, subject to Depositor's intellectual property rights in any of the Escrowed Materials and the licenses with respect thereto granted by Depositor to Beneficiary under the License Agreement.

RIGHT TO USE FOLLOWING RELEASE. Beneficiary shall have the right to use the Escrowed Materials pursuant to the license granted by Depositor to Beneficiary under the License Agreement. Beneficiary shall be obligated to maintain the confidentiality of the released Escrowed Materials as and to the extent required by the terms of the License Agreement.

DISPOSITION OF ESCROWED MATERIALS ON TERMINATION. Subject to the foregoing termination provisions, and on termination of this Escrow Agreement before the occurrence of a Release Condition, the Escrow Agent shall destroy the Escrowed Materials.

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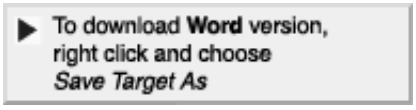
D. Sample Trust Agreement for Technical Support Services, Licensor Bankruptcy

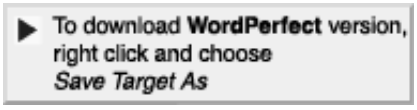
§12.88 1. Introduction

This sample trust agreement provides that the trust will step into the shoes of the licensor for purposes of providing technology support services to the licensor's customers in the event of the licensor's bankruptcy.

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§12.89 2. Form: Sample Trust Agreement for Technical Support Services, Licensor Bankruptcy





12.89-1 Sample trust agreement for technical support services, licensor bankruptcy

TRUST AGREEMENT

THIS TRUST AGREEMENT (this "Agreement") is executed as of _ _[*date*]_ _, by and among ABC.com, Inc., a Delaware corporation (together with its successors and assignees, the "Company"), and _ _[*name*]_ _ , as trustee (together with _ _[*his/ her/its*]_ _ permitted successors and assignees, the "Trustee").

RECITALS

This Agreement is entered into on the basis of certain facts and circumstances as described in these recitals:

A. The Company has established a program for the benefit of its customers known as the "ABC Business Assurance Program." The purpose of this program is to enhance the stability of ongoing technical and other support to participating customers, through the establishment of a separate entity to provide backup customer support in the event that the Company is unable or unwilling to provide such support, whether as a result of bankruptcy or otherwise.

B. To facilitate the continuity of services and support offered by the ABC Business Assurance Program, the Company has established this trust with the intent that this trust shall be a "bankruptcy-remote entity" and that the Trust Assets (as defined below) and the interests of the Company in the Trust (if any) shall be considered as excluded from the bankruptcy estate of the Company, in accordance with §541(c)(2) of the United States Bankruptcy Code (United States Code Title 11) (as amended, the "Bankruptcy Code").

C. To enable the Trust to perform its obligations under the ABC Business Assurance Program, the Company will license to the Trust certain intellectual property rights and provide copies of source code and other technology necessary for the performance of such services and will enter into certain co-tenancy arrangements and co-employment arrangements to further support the provision of services by the Trust.

D. Participating customers of the Company and its Subsidiaries will be entitled, on payment of a participation fee and subject to the terms of the ABC Business Assurance Program, to receive backup services and support from the Trust in respect of the Services Agreements (as defined below) entered between the Company or its Subsidiaries and such customers.

E. The Trust is not a surety, guarantor, or co-obligor and is not otherwise, directly or indirectly, liable or responsible for the performance of the Services Agreements by the Company. The Trust has been established and engaged by the Company solely for the purpose of acting as a backup service provider under the terms of this Agreement.

F. Should the Company become subject to any petition filed under the provisions of the Bankruptcy Code, the Trust shall continue to hold the Trust Assets for the purposes of providing services to the Customers (as defined below) in accordance with the terms of the Business Assurance Program, without being subject to any automatic stay or other restraint under Bankruptcy Code §362 or §105, or otherwise.

AGREEMENT

NOW, THEREFORE, for valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties agree as follows:

DEFINITIONS

1.1. DEFINITIONS. As used in this Agreement (including the recitals) the following terms shall have the following meanings:

***"Business Assurance Program"* means the ABC Business Assurance Program further described in the Business Assurance Program Agreement attached as Exhibit A hereto, as such program may be varied, supplemented, or modified from time to time in accordance with its terms.**

***"Co-Tenancy Agreement"* means the Co-Tenancy Agreement dated of even date herewith between the Company and the Trust, as amended, varied, supplemented, or otherwise modified from time to time, providing for access to and the right to use certain equipment of the Company and granting co-tenancy rights with respect to the premises where such equipment is located.**

***"Customers"* means the customers of the Company and its Subsidiaries who are participants from time to time in the Business Assurance Program, who have been identified in writing to the Trustee by the Company, and who have executed an acknowledgement, in form and substance reasonably satisfactory to the Trustee, in connection therewith.**

***"Customer Participation Fees"* means the participation fees payable by the Customers in connection with participation in the Business Assurance Program.**

***"License*" means the License and Services Agreement dated of even date herewith between the Company and the Trust, as amended, varied, supplemented, or otherwise modified from time to time, providing for, among other things, a limited, nonexclusive, nontransferable, nonassignable license to the Trust of certain intellectual property of Company.**

***"Person"* means an individual, corporation, partnership, joint venture, trust, unincorporated organization, any other entity of whatever nature, or any governmental agency or authority.**

***"Program Agreements"* means the License and Co-Tenancy Agreement.**

***"Program Fees"* means the fees, costs, and expenses payable from time to time by Customers in respect of Services provided by the Trust pursuant to the Business Assurance Program.**

***"Services"* means the back-up services to be provided or arranged by the Trust in respect of the Service Agreements pursuant to the Business Assurance Program.**

***"Service Agreements*" means the ABC Software Product Maintenance Agreements, ABC e-Source Service Agreements, and ABC Professional Services Agreements that are the subject of the back-up services to be provided or arranged by the Trust pursuant to the Business Assurance Program, together with such other agreements as may be designated pursuant to such program as Service Agreements.**

***"Subsidiary,"* with respect to any Person, means any corporation, association, partnership, joint venture, or other business entity of which more than 50 percent of the voting stock or other equity interest is owned directly or indirectly by such Person, by one or more of the other Subsidiaries of such Person, or by a combination thereof.**

***"Trust"* means the trust established pursuant to the terms of this Agreement and any successor trust.**

***"Trust Assets"* means all rights, title, interests, and property that are conveyed by the Company to the Trust from time to time, including the rights of the Trust pursuant to the Program Agreements and the Program Fees.**

1.2. INTERPRETATION. In this Agreement: (a) the meaning of defined terms shall be equally applicable to both the singular and plural forms of the terms defined; (b) the masculine gender shall include the neuter and feminine gender and vice versa; (c) the captions and headings are for convenience of reference only and shall not affect the construction of this Agreement; (d) the words "hereof," "herein," "hereto," "hereunder," and the like mean and refer to this Agreement as a whole and not merely to the specific Article, Section, subsection, paragraph, or clause in which the respective word appears; and (5) the words "including," "includes," and "include" shall be deemed to be followed by the words "without limitation."

THE TRUST

2.1. NAME. The name of the Trust shall be the "ABC Business Assurance Trust, L.L.C."

2.2. STATEMENT OF PURPOSE. The purposes of the Trust are:

(a) To enter into the Program Agreements and exercise the rights and powers of the Trust thereunder for the benefit of the Customers;

(b) To take custody and control of the Trust Assets; and

(c) To perform the obligations of the Trust pursuant to the Business Assurance Program.

The Trust shall not conduct any business other than that of performing the Services and Business Assurance Program. The Trust shall not dispose of any Trust Assets except as permitted by this Agreement or by the Business Assurance Program or as otherwise required for the performance of the Services and the purposes of the Trust.

2.3. CREATION OF TRUST ESTATE. The Company hereby: (a) agrees to execute and deliver to the Trust the Program Agreements; (b) transfers and assigns to the Trustee, on behalf of the Trust, all of its right, title, and interest in and to the Program Fees; and (c) agrees, on or promptly following execution of this Agreement, to deliver to the Trust copies of the materials and items described on Exhibit B.

2.4. ACCEPTANCE OF THE TRUST. The Trustee accepts the Trust Assets in trust and agrees to perform the obligations specified in this Agreement to be performed by the Trustee and otherwise to comply with and defend and enforce this Agreement and the Trust Assets. No implied duties or obligations shall be imposed on the Trustee by any Person.

2.5. IRREVOCABLE. Each of the Trust and this Agreement shall be irrevocable and shall continue as long as the Business Assurance Program continues in operation and any Customer continues to participate therein.

2.6. TAX MATTERS. The Trustee shall timely file such income tax returns as are required to be filed by the Trust and shall pay any income or other taxes owed by or on account of the Trust or the Trust Assets when due, out of the Trust Assets or any proceeds thereof.

2.7. COMPANY AS LIMITED BENEFICIARY. The interest of the Company in the Trust and the Trust Assets is limited to the Company's beneficial interest as specified herein and consisting of:

(a) The right to receive an amount equal to one-third of the aggregate total of Customer Participation Fees paid by Customers to the Trust.

(b) The right of the Company to receive income on the Trust Assets if and to the extent declared by the Trustee after having paid or made reasonable provision for the payment of current costs and expenses of the Trust (including reimbursement and compensation of the Trustee); provided that the Trust shall have no obligation to invest any Trust Assets or to otherwise account for interest or other income in respect of the Trust Assets; and

(c) The right to receive the residual assets of the Trust on termination of the Trust in accordance with the terms of this Agreement.

If the Company becomes subject to any case commenced by or against it under any provision of the Bankruptcy Code, the Trust Assets shall not be property of the Company or its estate under Bankruptcy Code §541. During the term of this Agreement, Trustee and the Company shall defend, accommodate, and recognize the rights and interests of the Trustee as provided in this Agreement.

2.8. CUSTOMERS AS LIMITED BENEFICIARIES. The interests of any Customer in the Trust are limited to:

(a) The right to receive performance of the Services in accordance with the Business Assurance Program; and

(b) The right to receive a refund of an amount equal to two-thirds of the Customer Participation Fee paid by such Customer if the Service Agreements of such Customer subject to the Business Assurance Program are terminated or expire (other than as a consequence of a breach by such Customer) in circumstances when the Trust has never initiated provision of any Services. In no event shall the Trust be required to account for interest or other income in respect of any such refunded amount.

The Company and Customers shall execute such documents and writings and shall take such action as reasonably specified by the Trustee so as to effectuate the performance or provision of the Services to be provided by the Trust. The Company and the Customers each represents, warrants, and agrees that any dispute that it may have with the Company or any Customers (as applicable) shall be addressed and resolved by them separately from the Trust and Trust Assets without involving the Trust or the Trustee. The Company and the Customers each acknowledge and agree that there are no obligations, liabilities, or duties of the Company or of any Customer that can affect, excuse, or impair any of the Company's or the Customers' obligations to the Trustee or to the Trust, or the Trust's obligation pursuant to the Business Assurance Program.

2.9. LIMITATIONS ON ALIENATION. Each beneficiary of this Trust is hereby restrained from selling, alienating, encumbering, transferring, or in any manner assigning its interest or estate in this Trust, and no such interest or estate shall be liable for the debts, liabilities, or obligations of any beneficiary, nor for any judgment or other legal or equitable process, proceeding, claim, or interest of creditors; provided, however, that the beneficial interest of any beneficiary hereunder shall inure to the successors of such beneficiary by merger, consolidation, or other reorganization.

2.10. CONSENT OF COMPANY TO PERFORMANCE BY TRUST. By its entry of this Agreement or participation in the Business Assurance Program (as applicable), the Company and each Customer hereby consent to the provision of the Services by the Trust in accordance with the terms of the Business Assurance Program, notwithstanding anything to the contrary in any Service Agreement. The Company shall assist the Trust in the transfer of materials and procurement of third party services and materials necessary to perform the Services.

2.11. TERM; TERMINATION.

(a) The Trust shall remain in existence indefinitely; provided, however, that this Agreement and the Trust may be terminated by the Company at such time as there are no longer any Customers and the Business Assurance Program has been terminated.

(b) On termination of this Agreement, all Trust Assets, including any cash held by the Trust, shall be transferred to the Company, as the residual beneficiary, after all other required payments (including any taxes and any fees, costs, and expenses of the Trust and Trustee) have been made.

2.12. NO BANKRUPTCY FILING. In no event shall the Trust be subject to, or commence, acquiesce in, or accede to any bankruptcy proceeding without the prior written consent of the Trustee and each beneficiary.

2.13. LIMITATION ON LIABILITY. In no event shall the Trust be liable for any consequential, special, punitive, exemplary, or indirect damages in respect of any alleged breach or wrongful conduct by the Trust or the Trustee (whether arising at law, in equity, or otherwise).

TRUSTEE

3.1. NUMBER; APPOINTMENT. Trustee shall be the sole Trustee of the Trust.

3.2. REPLACEMENT OR SUCCESSOR. The Company shall be entitled to remove the Trustee at any time, with or without cause, and to appoint a successor Trustee. The Trustee may be a natural person, corporation, trust company, partnership, or other business entity and shall have sufficient technical and business knowledge as to be able to assure performance of the Services; provided that, if the Company shall have been unable to identify a suitable Trustee meeting the requirements set forth above, the Company shall, pending the identification of a qualified Trustee, designate a bank, trust company, or other institution providing professional trust services as the interim Trustee hereunder. The appointment of a successor Trustee shall be made by an instrument in writing, signed by the Company, and delivered to the appointee. Any successor Trustee so appointed shall, on manifesting acceptance of such appointment in writing, become and be the Trustee

hereunder, with the same powers, duties, and authorities that such successor would have had if it had been named originally in this Agreement as the Trustee.

3.3. RESIGNATION. Without terminating the Trust, any Trustee shall cease to be the Trustee: (a) on death or incapacity, in the case of a natural person; or (b) on dissolution, receivership, bankruptcy, or other disability to perform its functions; or (c) on the effective date of its resignation. Any Trustee may resign as a Trustee without application to or consent of any court; provided that: (a) a qualified successor Trustee shall have first accepted appointment as a Trustee hereunder; and (b) the resigning Trustee shall give the Company and the Customers at least 20 days' prior notice of the effective date of such resignation. If no successor Trustee shall have been appointed on the resignation date, the Trustee may petition any court of competent jurisdiction for the appointment of a successor Trustee. Such resignation shall be made by written notice signed and acknowledged by the resigning Trustee and delivered to the Company.

3.4. TRUSTEE'S POWERS. Except as expressly provided herein, the Trustee shall have all such powers as shall be necessary or appropriate for the effective and timely administration of the Trust, and performance of the Business Assurance Program including, but not by way of limitation, the following powers:

(a) To discharge (or cause to be discharged) and perform all obligations and responsibilities assigned to the Trustee pursuant to the terms of this Agreement, the Program Agreements, and the Business Assurance Program, and to administer the Trust as the holder of the Trust Assets.

(b) To manage and operate the Trust Assets and any and all of the rights or interests at any time held hereunder in accordance with this Agreement.

(c) To join or become a party to or to oppose any reorganization, readjustment, recapitalization, foreclosure, merger, voting trust, dissolution, consolidation, or exchange; to deposit any securities with any committee, depository, or trustee; to pay any fees, expenses, and assessments incurred in connection therewith; to charge the same to principal; to exercise conversion, subscription, or other rights; and to make any necessary payments in connection therewith.

(d) To prosecute, defend, compromise, arbitrate, or otherwise adjust or settle claims in favor of, or against, the Trustee or the Trust Assets.

(e) To appoint, employ, and compensate, on such terms as the Trustee may determine in its reasonable discretion, out of the Trust Assets, one or more agents, accountants, managers, attorneys-in-fact, attorneys-at-law, and other professional persons as the Trustee may deem necessary or proper for the performance of this Agreement and administration of the Trust. The Trustee shall have no liability for any misconduct, neglect, default, or omission of any such agent or professional representative appointed or employed pursuant to this paragraph, provided reasonable care is exercised in their selection and employment and such selection is approved by the Company.

(f) To execute any of the trusts or powers hereunder or perform any duties under this Agreement either directly or by or through agents or attorneys, including anything that an owner of property similar to the Trust Assets would do in the reasonable course of its business.

(g) To employ or retain, on such terms as the Trustee may determine in its reasonable discretion, and compensate out of the Trust Assets such employees and independent contractors as the Trustee may deem necessary, proper, or appropriate for the performance of the Services and the Business Assurance Program, or otherwise in connection with the administration of the Trust and performance of the Trust's purposes.

(h) To establish one or more working capital accounts for purposes of administering the Trust Assets.

(i) To invest Trust Property as Trustee in its sole discretion determines reasonable and to lend, guarantee, and otherwise extend credit or provide financial support for the purposes of performing or supporting the Trust purposes.

(j) To borrow money or otherwise incur credit, and to provide collateral and other forms of credit enhancement, for the purposes of administering the Trust and performing the Trust's purposes.

(k) To insure Trust Assets and the Trust against such risks or liabilities as the Trustee shall determine

in its reasonable discretion (including in respect of the performance of the Services), and to settle, compromise, prosecute, and defend all claims in respect of any such insurance.

(l) To exercise any other rights or powers conferred on trustees by statute (including powers available to trustees pursuant to the Trust Indenture Act of 1939, as amended).

3.5. GENERAL AUTHORITY. In amplification of, and without limiting any of the powers granted to the Trustee(s), the Trustee shall have full power, authority, and discretion to deal reasonably with any situation that may arise respecting the Trust Assets or any part thereof in such manner as the Trustee shall deem advisable or otherwise in the best interests of the beneficiaries hereunder, including doing all such acts and entering into all such agreements as Persons owning similar property in their own right might lawfully, exercise, do, or enter into, consistent with the express provisions of this Agreement. The grant to the Trustee of any specific power, authority, or discretion, or the failure to grant specifically herein any other power, authority, or discretion, except as expressly provided otherwise in this Agreement, shall not be construed to limit or curtail in any way or to any extent such power, authority, and discretion, which it is intended and directed shall be exercisable at all times by the Trustee respecting any and all matters of any character pertaining to all or any part of the Trust Assets, consistent with the express requirements of this Agreement.

3.6. INDEMNIFICATION. The Company and the Trust agree to defend and hold the Trustee and its officers, directors, agents, attorneys, employees, and representatives (each an "Indemnified Person") harmless from, and to indemnify them against, any losses, liabilities, expenses (including reasonable attorney fees and expenses), claims, damages, or demands that result from the performance of the Indemnified Person's duties hereunder or that are reasonably incurred by the Indemnified Person by reason of or in relation to its administration of the Trust, performance of the Trust Agreements, or otherwise in connection with the Business Assurance Program; except to the extent attributable to such Indemnified Person's own willful misconduct or gross negligence, as finally determined by a court of competent jurisdiction. All costs and expenses incurred in defending any action or suit may be paid from the Trust Assets to the Trustee (or any of the Indemnified Persons) as incurred by them, even though in advance of the final disposition of such action or suit. The indemnities in this paragraph shall survive the resignation of any Trustee (or any and other Indemnified Person) and the termination of this Agreement. In no event shall the Trustee be liable for, and the Trustee shall be indemnified against, any liability (whether of the Trust or otherwise) arising out of the manner or performance of the Services by or on behalf of the Trust, it being the role of the Trustee merely to facilitate provision of the Services and not to monitor or otherwise direct the manner of the performance of the Services; provided, however, that nothing herein shall limit or restrict the liability of the Trust, as distinct from the Trustee, for the performance of Services by the Trust.

3.7. COMPENSATION AND REIMBURSEMENT. The compensation of the Trustee for serving in such capacity shall be as agreed to in writing by the Company and the Trustee from time to time. All Trustee compensation shall be paid by the Company. If Trustee is unable to obtain payment from the Company, the Trustee may reimburse itself out of the Trust Assets. In the event that the Trustee and Company are unable to agree on the compensation of the Trustee, the Trustee shall be entitled to reasonable and appropriate compensation for services actually performed, on a per hour, per diem, or other appropriate basis, to be paid out of the Trust Assets.

3.8. LIABILITY.

(a) The duties and obligations of the Trustee shall be determined solely by the express provisions of this Agreement. The Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in this Agreement. No implied covenants or obligations shall be read into this Agreement against the Trustee, and, in the absence of bad faith on the part of the Trustee, the Trustee may conclusively rely, as to the truth of the statements and the correctness of the facts or opinions expressed in this Agreement, on any certificates or opinions furnished to the Trustee and conforming to the requirements of this Agreement. The Trustee shall not, and may not be directed to, take any action (or omit to take action) that is inconsistent with this Agreement.

(b) The Trustee shall not have any liability for any action taken, or for refraining from taking action, in good faith pursuant to this Agreement; provided, however, that this provision shall not protect the Trustee against any liability that would otherwise be imposed by reason of willful misconduct or gross negligence in the performance of its duties.

(c) It is acknowledged and agreed that the principal purpose of the Trust is to own and hold the Trust Assets.

3.9. BOND. The Trustee shall not be required in this or any other jurisdiction to furnish any bond or security for the faithful performance of the Trustee's duties.

3.10. NOT ACTING IN INDIVIDUAL CAPACITY. In accepting the Trust hereby created, the Trustee is acting solely as trustee hereunder and not in any individual capacity. The Trustee may execute any documents and perform any action indicating that it is executing such documents or performing such action as the Trustee and not in its individual capacity or words to the same effect, but failure to do so shall not give rise to any presumption that the Trustee is acting or incurring liability in its individual capacity. Through its participation in the Business Assurance Program, each Customer acknowledges and accepts that the Trustee may be an employee, officer, or director (or former employee, officer, or director) of the Company or its Subsidiaries and that the Company is responsible for paying and settling the compensation of the Trustee. Each Customer acknowledges the potential conflict of interest presented by such connections and knowingly waives and agrees not to assert any objections to any such potential conflict of interest.

3.11. ACTIONS DURING PENDENCY OF CERTAIN DISPUTES. If a dispute arises with respect to the Trust Assets, or with respect to the termination of the Trust, or with respect to both, as the case may be, the Trustee is directed to retain in its possession, without liability to anyone, all or any part of the Trust Assets until such dispute shall have been settled either by mutual agreement by the parties concerned or by a decision of a court or arbitral tribunal; provided such decision has not been stayed.

REPORTS AND RECORDS

4.1. REPORTS AND RECORDS. The Trustee shall cause to be prepared, on the termination of the Trust and at such other dates as the Company may request, and shall deliver a report showing the assets and liabilities of the Trust at the end of such fiscal year, or on such termination, and the receipts and disbursements of the Trustee for such period. The Trustee may submit similar reports for such interim periods as the Trustee deems advisable.

4.2. OTHER REPORTS. The Trustee shall prepare and provide such other reports as may be required by applicable law from time to time in effect.

MISCELLANEOUS

[*Add customary miscellaneous agreement provisions*]

[*Add signature blocks*]

EXHIBIT A

BUSINESS ASSURANCE PROGRAM AGREEMENT

This Business Assurance Program Agreement ("Agreement") is made by and among ABC.com, Inc. ("ABC"), _ _[*name of trust*]_ _ (the "Trust"), and Customer (as identified in the signature block below) as of _ _[*date*]_ _ (the "Effective Date").

A. Customer has purchased from ABC certain services or licenses related to ABC's software.

B. ABC has, through the Trust, established a capability to provide certain services related to ABC's software independently of ABC in a backup capacity, and offers such services to its customers (the "Business Assurance Program").

C. Customer desires to participate in the Business Assurance Program to receive certain backup services from the Trust under the terms and conditions of this Agreement.

Capitalized terms used herein that are not defined in this Agreement shall have the definitions ascribed to them in the Services Agreement.

1. SERVICES AGREEMENT. Customer and ABC have entered into the following agreement(s) with respect to

which Customer desires to receive the Services (as defined in Section 2) set forth in this Agreement:

[*List applicable agreements between Customer and ABC*]

Such agreement(s) are hereafter referred to individually as a "Services Agreement" and collectively as the "Services Agreements."

2. SERVICES. For purposes of this Agreement, "Services" means the services (including the use and operation of ABC software on behalf and for the benefit of Customer pursuant to a license granted by ABC to Customer) that meet the following criteria: (a) services described in Services Agreements that are in full force and effect; (b) services described in Services Agreements for which Customer has timely made and is currently up-to-date in payments; and (c) services described in Services Agreements that are identified on the following list:

[*List specific services by specific reference to particular sections of the Services Agreements.*]

3. TRUST BACKUP SERVICES. The Trust agrees to provide the Services to Customer in accordance with the applicable Services Agreements and the terms of this Agreement, and Customer and ABC hereby consent to the Trust's provision of such Services. Following the occurrence of a Triggering Event (as defined below), Customer may notify the Trust of such occurrence and, on receipt of such notice, the Trust shall acknowledge such notice and thereafter the Trust shall perform the Services for Customer in accordance with the applicable Service Agreements, provided that Customer has subscribed for and complied with its obligations to receive the Services under, and is not in material breach of, the terms and conditions of the Services Agreements. "Triggering Event" shall mean any of the following:

(a) ABC, either itself or through its subcontractors, fails in any material respect to provide Customer with the Services purchased by Customer strictly in accordance with the requirements of the Services Agreements and such failure or breach is not cured within 20 days following notification of such failure or breach from Customer; provided that if, as a result of such failure or other breach, Customer's Marketplace (as defined in the Services Agreements) is down, causing critical impact to Customer's operations if the Services are not restored, or Customer's Marketplace is severely degraded, impacting significant aspects of Customer's business operations, such failure or breach is not cured within 2 calendar days;

(b) ABC, the Trust, and Customer agree in writing that the Trust should commence provision of the Services to Customer; or

(c) ABC commences a voluntary proceeding under Title 11 of the United States Code (as now constituted or hereafter amended) or any other federal or state bankruptcy, insolvency, receivership, or similar law ("U.S. Bankruptcy Law"), is the subject of a petition filed against it commencing an involuntary bankruptcy proceeding under U.S. Bankruptcy Law, or fails to generally pay its debts as they become due or is insolvent under U.S. Bankruptcy Law.

(d) ABC makes a general assignment for the benefit of its creditors;

(e) A receiver, trustee, custodian, or similar officer is appointed for or over ABC or any substantial part of its property;

(f) ABC generally ceases providing support for the Marketplace Software; or

(g) ABC is dissolved or ceases to do business in the ordinary course.

4. TRUST AS THIRD PARTY BENEFICIARY. The parties agree that the Trust is a third party beneficiary to the Services Agreements with respect to the Services provided thereunder and is entitled to the benefits of the Services Agreements as if it were a party thereto, including, without limitation, the benefits of any payment provisions, disclaimers of warranties, and limitations of liability provisions.

5. PROVISION OF SERVICES BY THE TRUST. Customer hereby consents to the provision of the Services by the Trust. The parties agree that the Trust shall act as a subcontractor to ABC for the provision of the Services. The Trust shall comply with all the obligations of ABC under the Services Agreements that are applicable to the provision of the Services, including but not limited to, ABC's confidentiality obligations.

6. INDEPENDENT CONTRACTORS. Nothing in this Agreement shall be construed as creating a partner, joint venture, or agency relationship between ABC and the Trust. ABC and the Trust each acknowledge that they are independent contractors and that the relationship between them shall not constitute a partnership, joint venture, or agency. Neither ABC nor the Trust shall have the authority to make any statements, representations, or commitments of any kind, or to take any action that is binding on the other party, without the prior consent of the other party to do so.

7. PAYMENTS FOR SERVICES. The Trust may invoice the Customer directly for Services. Customer shall pay the Trust directly for any Services provided by the Trust under this Agreement in accordance with the terms of the applicable Services Agreement. The Trust may not invoice Customer for Services that have been prepaid by Customer to ABC.

8. PAYMENTS FOR MEMBERSHIP IN BUSINESS ASSURANCE PROGRAM. As payment for participation in the Business Assurance Program, ABC shall invoice Customer for the fees set forth below:

[*Fee amounts to be added based on ABC-provided information*]

Customer shall make such payments within 30 days of date of invoice. Payments for the Business Assurance Program are nonrefundable, except that two-thirds of such paid amounts shall be refunded to Customer on termination of this Agreement if the Trust has not commenced any of the Services to Customer under this Agreement.

9. TERM.

(a) This Agreement shall be effective on the Effective Date and shall continue thereafter in full force and effect until December 31, 2015, unless and until terminated as provided herein. At the end of such term and at the end of each subsequent term thereof, this Agreement shall be renewed automatically for an additional 1-year term, unless either party delivers written notice of termination to the other party no less than 90 days prior to the end of the current term.

(b) ABC or the Trust shall have the right to terminate this Agreement on giving 30 days' prior written notice of such termination to Customer in the event that Customer is in material breach of any provision of this Agreement and does not cure such breach within 30 days after receipt of the notice. Customer shall have the right to terminate this Agreement on giving 30 days' prior written notice of such termination to the Trust and ABC in the event that the Trust or ABC is in material breach of any provision of this Agreement and does not cure such breach within 30 days after receipt of the notice.

(c) ABC shall have the right, on 15 days' prior written notice to the Trust and Customer, to terminate this Agreement at such time as all of the Services Agreements have either expired or terminated for any reason.

(d) On termination of this Agreement for any reason, the Trust shall immediately cease the provision of all Services. In the event of expiration or termination of this Agreement for any reason, Sections _ _[*add numbers*]_ _ shall survive.

10. RECOMMENCEMENT OF SERVICES BY ABC. ABC shall have the right to terminate this Agreement and to recommence provision of Services to all Customers then currently receiving Services from the Trust, in the event that ABC, the Trust, and such Customer agree in writing that ABC should recommence provision of the Services to Customer.

[*Add customary miscellaneous agreement provisions.*]

[*Add signature blocks*]

EXHIBIT B

List of Technology to be Delivered

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Appendix A

Sample Patent License Agreement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

PATENT LICENSE AGREEMENT

THIS AGREEMENT (this "Agreement"), dated to be effective as of _ _[*date*]_ _ (the "EFFECTIVE DATE"), is between _ _[*name*]_ _ ("LICENSOR"), a _ _[*jurisdiction*]_ _ corporation, with its principal place of business at _ _[*address*]_ _, and _ _[*name*]_ _ ("LICENSEE"), a _ _[*jurisdiction*]_ _ corporation, with its principal place of business at _ _[*address*]_ _.

RECITALS

A. LICENSOR warrants that it is the owner and that it has the right to exclusively license the inventions that are the subject matter of the patent applications listed in Appendix A;

B. LICENSEE desires to obtain an exclusive license in the FIELD OF USE (as defined below) to, among other things, manufacture and market products utilizing the PATENTS and PRODUCTS (as those terms are defined below);

C. LICENSOR is willing to grant a worldwide, exclusive license in the FIELD OF USE to LICENSEE, subject to the terms, conditions, limitations, and restrictions set forth in this Agreement.

AGREEMENT

NOW, THEREFORE, in consideration of the mutual promises contained in this Agreement, the parties agree as follows:

1. DEFINITIONS

For all purposes of this Agreement, the following terms have the meanings specified below:

a. "PATENT" means any and all U.S. and foreign patents and patent applications listed in Appendix A (Appendix A may be added to from time to time by LICENSOR, and LICENSOR shall notify LICENSEE of any such additions), any and all patents issued thereon, or any continuation, division, extensions, or reissues thereof, continuation-in-part applications (but only to the extent of LICENSOR's rights in such continuation-in-part applications and provided that LICENSOR has the legal right to grant such rights), and any and all applications that claim priority to the foregoing, whether foreign or domestic, and all foreign patents issuing from any application filed that corresponds to claims contained in any of the foregoing patents or applications.

b. "PRODUCT" means any article, composition, apparatus, substance, chemical, material, method, or service that is made, used, distributed, or sold by LICENSEE:

i. That is covered in whole or in part by one or more pending or unexpired claims contained in a PATENT in the country in which the PRODUCT is made, used, distributed, or sold;

ii. That is manufactured using a method or process that is covered in whole or in part by one or more pending or unexpired claims contained in a PATENT in the country in which (a) the PRODUCT is made, used, distributed, or sold, or (b) the method or process is used or sold; or

iii. The use of which is covered in whole or in part by one or more pending or unexpired claims contained in a PATENT in the country in which (a) the PRODUCT is made, used, distributed, or sold, or (b) the method or process is used or sold.

c. A PRODUCT is "covered by a pending or unexpired claim of a PATENT" if in the course of manufacture, use, distribution, or sale, it would, in the absence of this Agreement, infringe one or more claims of the PATENT that has not been disclaimed or held invalid by a court from which no appeal can be taken.

d. "FIELD OF USE" means _ _[*description*]_ _.

e. "NET SALES PRICE" means the gross billing price of any PRODUCT received by LICENSEE or its SUBLICENSEE for the sale or distribution of any PRODUCT, less the following amounts actually paid by LICENSEE or SUBLICENSEE: (i) discounts allowed; (ii) returns; (iii) transportation charges or allowances; (iv) packing and transportation packing material costs (not including product containers or product packing containers as manufactured by the LICENSEE); (v) customs and duties charges; and (vi) sales, transfer, and other excise taxes or other governmental charges levied on or measured by sales, but no franchise or income tax of any kind whatsoever.

Every commercial use or disposition of any PRODUCT, in addition to a bona fide sale to a customer, shall be considered a sale of such PRODUCT. The NET SALES PRICE, in the case of a use or disposition other than a bona fide sale, shall be equivalent to the then-payable NET SALES PRICE of such PRODUCT in an arm's-length transaction.

f. "SUBLICENSEE" means any third party licensed by LICENSEE to practice the rights LICENSEE has under this Agreement, such as to make or sell any PRODUCT in accordance with the terms of this Agreement.

g. "INVESTMENT CAPITAL" means funds received by LICENSEE in exchange for stock ownership in LICENSEE, but shall not include funds from third parties for research and development efforts by LICENSEE or funds received from third parties in the way of royalties or fees.

2. LICENSE PHASE

a. In consideration of the license fee and royalties and subject to the other terms and conditions set forth in this Agreement, LICENSOR hereby grants to LICENSEE:

i. The exclusive worldwide license in the FIELD OF USE to use the PATENT to make, use, sell, offer for sale, have made, export, and import PRODUCTS; and

ii. The right to grant sublicenses to any PATENT licensed exclusively hereunder, provided that any SUBLICENSEE agrees to be bound by the terms and conditions of this Agreement applicable to SUBLICENSEES.

b. In addition to the royalty referred to in Paragraph 4, LICENSEE shall pay LICENSOR a license fee of $_ _[*amount*]_ _, payable according to the following schedule:

i. Within _ _[*number, e.g., 15*]_ _ days of the EFFECTIVE DATE, a $_ _[*amount*]_ _ initial payment,

ii. Within _ _[*number, e.g., 45*]_ _ days of the initial payment, a second payment of $_ _[*amount*]_ _.

iii. On the 15th of each month thereafter, an additional $_ _[*amount*]_ _ until the remaining $_ _[*amount*]_ _ and any patent expenses accruing in the interim have been paid.

c. Further, LICENSEE shall issue to LICENSOR a portion of LICENSEE stock. LICENSEE shall issue shares of LICENSEE's stock, equal to _ _[*number, e.g., 1*]_ _ percent of the total outstanding shares, within 60 days following LICENSEE's cumulatively raising at least $_ _[*amount*]_ _ in INVESTMENT CAPITAL.

3. ROYALTY

a. On all sales of PRODUCTS anywhere in the world by LICENSEE or its SUBLICENSEE, LICENSEE shall pay LICENSOR a royalty according to the following schedule:

i. For sales less than $_ _[*amount*]_ _ each year, a royalty of _ _[*number, e.g., 0.5*]_ _ percent of the NET

SALES PRICE.

ii. For sales between $_ _[*amount*]_ _ and $_ _[*amount*]_ _ each year, a royalty of _ _[*number, e.g., 1*]_ _ percent of the NET SALES PRICE.

iii. For sales between $_ _[*amount*]_ _ and $_ _[*amount*]_ _ each year, a royalty of _ _[*number, e.g., 1.5*]_ _ percent of the NET SALES PRICE.

iv. For sales greater than $_ _[*amount*]_ _ each year, a royalty of _ _[*number, e.g., 2*]_ _percent of the NET SALES PRICE.

b. In order to sell PRODUCTS, LICENSEE or its SUBLICENSEE may be required to pay royalties to third parties. For cumulative third party royalties above _ _[*number, e.g., 3*]_ _ percent of the NET SALES PRICE, LICENSEE or its SUBLICENSEE may offset _ _[*fraction, e.g., one-half*]_ _ of such payments to reduce the royalty payment otherwise due LICENSOR under Paragraph 3.a, provided that the royalty paid to LICENSOR shall in no event be reduced to lower than _ _[*number, e.g., 1*]_ _ percent of the NET SALES PRICE. If any PRODUCT sold by LICENSEE is covered only by a pending claim or claims as described in Paragraph 1.c, and more than _ _[*number, e.g., 4*]_ _ years have elapsed from the EFFECTIVE DATE, then LICENSEE may, after the _ _[*number, e.g., 4*]_ _-year anniversary of the EFFECTIVE DATE, withhold payment of royalties due LICENSOR under this paragraph until such time as a patent issues containing such claim or claims, at which point LICENSEE shall pay LICENSOR the withheld royalties. If no patent ever issues containing such claim or claims, LICENSEE shall have no royalty obligation with respect to such pending claim or claims after the _ _[*number, e.g., 4*]_ _-year anniversary of the EFFECTIVE DATE.

c. In addition to the royalty described in Paragraph 3.a., LICENSEE shall pay LICENSOR _ _[*number, e.g., 3*]_ _ percent of revenue received from a SUBLICENSEE, provided that this payment shall not apply to: (i) earned royalty, (ii) prepaid royalty, (iii) reimbursement of patent costs, (iv) reimbursement of license fees paid by LICENSEE to LICENSOR, (v) funds for research and development by LICENSEE, (vi) consulting fees paid to LICENSEE for actual, verifiable consulting services performed by employees of LICENSEE equivalent to such fees that would be paid in an arm's-length transaction, or (vii) reimbursement of expenses, including legal and travel expenses, associated with the sublicense.

d. LICENSEE will pay an annual minimum royalty. The minimum royalty on the PRODUCTS will be $_ _[*amount*]_ _ commencing on the second year after LICENSEE or its SUBLICENSEE's annual sales of PRODUCT reaches a total $_ _[*amount*]_ _ and for each succeeding year up to the date of expiration of the last PATENT. Minimum royalties are to be paid biannually to LICENSOR, one half due and payable on January 1 of each year and the second half due and payable on July 1 of each year. Should LICENSEE fail to make earned royalty payments sufficient to meet said minimum royalty requirements, it may pay the difference between the earned royalty and the minimum royalty requirement to keep this Agreement in force. Unless LICENSEE is required to deliver a written earned royalty report under Paragraph 3.e corresponding to the quarter in which minimum royalties are due, LICENSEE shall deliver a report including the information itemized in Paragraph 3.e at the time it pays that respective minimum royalty.

e. Except for the annual minimum royalty payable under Paragraph 3.d, LICENSEE shall pay royalties to LICENSOR on a calendar quarter basis. Within 30 days after the end of each calendar quarter, LICENSEE shall deliver to LICENSOR a full and accurate accounting to include at least the following information, which LICENSOR shall maintain in confidence in accordance with Paragraph 16:

i. Quantity of each PRODUCT sold (by country) by LICENSEE and its SUBLICENSEES;

ii. Total gross receipts and NET SALES PRICE for each PRODUCT (by country);

iii. Quantities of each PRODUCT used by LICENSEE and its SUBLICENSEES;

iv. Names and addresses of SUBLICENSEES of LICENSEE;

v. Total number of PRODUCTS manufactured (by country); and

vi. Total royalties payable to LICENSOR.

f. In each year the amount of royalty due shall be calculated quarterly as of March 31, June 30, September 30, and December 31 and shall be paid quarterly within the next 30 days following such date. Every such payment shall be supported by the accounting prescribed in Paragraph 3.e and shall be made in United States currency. Whenever conversion from foreign currency shall be required for the purpose of calculating royalties, the conversion shall be at the rate of exchange thereafter published in the Wall Street Journal for the business day closest to the applicable end of calendar quarter.

g. The royalty payments due under this Agreement shall, if overdue, bear interest until payment at a per annum rate equal to _ _[*number, e.g., 1.5*]_ _ percent above the prime rate in effect at Bank of America, San Francisco on the due date, not to exceed the maximum permitted by law. The payments of such interest shall not preclude LICENSOR from exercising any other rights it may have as a consequence of the lateness of any royalty payment.

4. RIGHTS RETAINED BY LICENSOR

Notwithstanding the exclusive license granted in Paragraph 2.a, LICENSOR shall have the absolute, nontransferable right to use the technology covered by the PATENTS and all improvements of the PATENTS, for conducting research and for educational purposes.

5. PATENT PROSECUTION

a. LICENSOR shall file, prosecute, and maintain, during the course of this Agreement, the PATENTS. Should LICENSEE require the filing of foreign patents, LICENSOR shall take responsibility for filing, prosecuting, and maintaining the foreign patents.

b. LICENSEE shall reimburse all reasonable legal expenses incurred and paid by LICENSOR in filing, prosecuting, and maintaining the U.S. and foreign applications listed (or to be listed in accordance with Paragraph 1.a) in Appendix A, whether such expenses were incurred before or after the date of this Agreement, provided that LICENSEE may credit the annual minimum royalty payable under Paragraph 3.d against such patent expenses. These legal expenses shall include the attorney and agent fees, foreign filing fees, and out-of-pocket costs associated with responding to office actions, and any other fees and costs directly related to obtaining or maintaining patent protection in the countries listed in Appendix A. LICENSEE shall advance payments of maintenance fees and annuities as part of such legal expenses to be reimbursed by LICENSEE within 30 days of request by LICENSOR, unless LICENSEE is advised otherwise by timely notice from LICENSOR.

c. If LICENSEE elects (i) not to pursue any PATENT or (ii) to terminate the prosecution or maintenance of all PATENTS in any country, LICENSEE surrenders its right to make, use, or sell PRODUCTS covered by the nonelected PATENTS in that particular country and shall grant to LICENSOR the exclusive rights previously granted to LICENSEE, without limitation, for that country. LICENSEE agrees to execute all necessary documents to carry out this grant of rights to LICENSOR. Payments referred to in Paragraphs 6.a and 6.b shall not be refunded on any such nonelection or termination.

6. PATENT INFRINGEMENT

a. Defensive Controversy

LICENSEE shall promptly notify LICENSOR of all claims, allegations, and notifications of infringement of third party patents. Except for the placing in escrow of a portion of royalties as referred to below, LICENSOR shall have no obligation or liability in the event that legal action is brought against LICENSEE for patent infringement. Such obligation and liability shall be borne by LICENSEE. LICENSEE may choose legal counsel and defend the patent infringement lawsuit. During such lawsuit, LICENSEE may place all of the royalties derived from sales of the PRODUCT in the country where such lawsuit is pending in an interest-bearing escrow account. The escrow account shall be established in a bank mutually acceptable to both parties under escrow instructions insulating the funds from claims of any creditor. On termination of the action, _ _[*fraction, e.g., 1/2*]_ _ of any judgment amount, and reasonable attorney fees and costs, may be paid from this escrow account. Should the settlement of any such patent infringement lawsuit involve payment of royalties by LICENSEE to a third party for the continued right to manufacture, use, and sell the PRODUCT, then funds in the escrow account and royalties payable to LICENSOR may be applied against up to _ _[*fraction, e.g., 1/2*]_ _ of such royalties to a third party. Any funds thereafter remaining in the escrow shall be paid to LICENSOR. The

above shall constitute LICENSOR's sole liability and responsibility in the event of such action. Royalties paid to third parties as provided for above shall be included when determining whether the minimum royalty provided for in this Agreement has been paid in a given year.

b. Offensive Controversy

LICENSEE shall promptly notify LICENSOR of any potential infringement of a PATENT. In the event that a third party infringes on a PATENT, LICENSEE shall have the right but not an obligation to bring legal action to enforce any such patent. If LICENSEE exercises such right, LICENSEE shall select legal counsel and pay all legal fees and costs of prosecution of such action. In the event that LICENSEE shall choose not to take such action, LICENSOR shall have the right, at its option and at its own expense, to prosecute any action to enjoin such infringement or to prosecute any claim for damages. The party prosecuting any such action shall be entitled to retain any funds received as a result of settlement or judgment of such action. The parties may also agree to jointly pursue infringers. After deduction and payment to the parties of their respective costs and fees (including without limitation reasonable attorney fees) incurred in prosecuting any such actions, the net funds, if any, obtained as a result of settlement or of judgment of any such jointly prosecuted action shall be divided in the following manner: _ _[*number, e.g., 25*]_ _ percent of all net funds shall be divided equally by the parties and _ _[*number, e.g., 75*]_ _ percent of all the net funds shall be divided between the parties as follows: LICENSEE shall receive R/(R + U) and LICENSOR will receive U/(R + U) of the _ _[*number, e.g., 75*]_ _ percent of the net funds, where "R" is the amount of lost profits suffered by LICENSEE due to the infringement and "U" is the amount of lost royalties suffered by LICENSOR due to the infringement.

c. During any litigation under this Paragraph 6, both parties shall keep each other timely informed of any significant developments in the litigation and provide all reasonably requested technical assistance. During any such litigation, full royalty payments shall continue, except as otherwise provided in this Agreement.

7. RECORDS

LICENSEE and SUBLICENSEES shall keep complete, true, and accurate books of account and records for the purpose of showing the derivation of all amounts payable to LICENSOR under this Agreement. The books and records shall be kept at LICENSEE's principal place of business for at least 4 years following the end of the calendar year to which they pertain and shall be open at all reasonable times for inspection by a representative of LICENSOR for the purpose of verifying LICENSEE's royalties statements or LICENSEE's compliance in other respects with this Agreement. All information obtained as a result of such audit shall be maintained in confidence, except that the representative may disclose to LICENSOR the aggregate amount of royalties due to LICENSOR during each year, as determined in such audit. Should an audit by LICENSOR show an underpayment of royalties by more than _ _[*number, e.g., 10*]_ _ percent, LICENSEE shall immediately pay such underpayment and all interest, as well as for LICENSOR's reasonable audit expenses.

8. SERVICES OF INVENTORS

LICENSOR shall make reasonable efforts to make inventors available during regular business hours to answer questions concerning certain technical aspects of the PATENTS. Should LICENSEE wish to use the services of inventors for further testing or market studies, a separate research and development or consulting agreement shall be negotiated with inventors and the LICENSOR.

9. SUBLICENSE PERMISSION

LICENSEE may sublicense PATENTS only with prior written permission from LICENSOR, which permission shall not be unreasonably withheld. Notwithstanding the foregoing, no permission shall be granted for a sublicense unless the SUBLICENSEE agrees in writing to be bound by the terms of this Agreement.

10. PATENT MARKING

LICENSEE shall use reasonable efforts to place all appropriate patent and other intellectual property notices, markings, and indicia on product and marketing literature for the PRODUCTS as needed to protect the patent and other intellectual property rights of LICENSOR and right for damages for infringement.

11. PUBLICATIONS

Nothing in this Agreement shall limit or prevent LICENSOR from publishing any information about the PATENT. Thirty days before submission for publication, LICENSOR shall use its reasonable efforts to submit the proposed publication, for review only, to LICENSEE.

12. PUBLICITY

Neither party shall use the name, trade name, trademark, or other designation of the other party in connection with any products, promotion, or advertising without the prior written permission of the other party

13. ASSIGNMENTS, TRANSFERS

LICENSEE may not assign or transfer this Agreement in whole or part to any third party without the prior written permission of LICENSOR, which permission shall be granted in the sole discretion of LICENSOR. LICENSEE may only assign the entire Agreement to successors of the entire business of the PRODUCTS if the successor agrees to be bound by this Agreement and prior written notice is provided to LICENSOR.

14. TERMINATION

a. On a breach of or default under this Agreement by either party, the nonbreaching party may terminate this Agreement by _ _[*number, e.g., 45*]_ _ days' prior written notice to the breaching party and to any SUBLICENSEE. The notice shall be effective at the end of that period unless during that period the breaching party remedies such breach or default. LICENSEE may also terminate this Agreement at any time, for any reason, by providing LICENSOR a _ _[*number, e.g., 90*]_ _ days' prior written notice. No royalties or other license fees shall be returnable. This Agreement may also be terminated immediately by LICENSOR on notice to LICENSEE on the occurrence of any of the following: (i) LICENSEE attempts to use, sublicense, transfer, or assign its rights or obligations under this Agreement in any manner contrary to the terms of this Agreement or in derogation of LICENSOR's proprietary rights; (ii) LICENSEE fails to obtain and maintain the insurance coverages required by Paragraph 23; or (iii) LICENSEE is determined to be insolvent or makes an assignment for the benefit of creditors, or has a bankruptcy petition filed by or against it, or a receiver or trustee in bankruptcy or similar officer is appointed to take charge of all or part of LICENSEE's property. On termination of this Agreement, all rights granted to or provided by each party to the other shall automatically and irrevocably revert to the granting party.

b. Surviving any termination of this Agreement are:

i. LICENSEE's obligation to pay royalties accrued or accruable;

ii. LICENSEE's obligation of Paragraph 7 to keep and allow a final audit;

iii. Any cause of action or claim of LICENSEE or LICENSOR, accrued or to accrue, because of any breach or default by the other party; and

iv. The provisions of Paragraphs 21, 22, and 23.

c. On termination of this Agreement, LICENSEE agrees to immediately discontinue the manufacture and sale of the PRODUCTS and the use of the PATENTS. Within _ _[*number, e.g., 20*]_ _ days after such termination, LICENSEE shall provide LICENSOR with a written inventory of all PRODUCTS currently in its stock as of the date of termination (the "INVENTORY"). LICENSEE shall have the right to dispose of the INVENTORY at its normal prices within _ _[*number, e.g., 3*]_ _ months after the date of termination. LICENSEE shall dispose of the INVENTORY only to customers who had previously purchased PRODUCTS from LICENSEE during the term of this Agreement, and in no event shall LICENSEE sell the INVENTORY to wholesalers, diverters, jobbers, or any other entity that does not sell at retail exclusively or to anyone else who intends to sell the INVENTORY at close-out. The disposition of all INVENTORY shall be subject to all of the terms and conditions of this Agreement. After the _ _[*number, e.g., 3*]_ _ month sell-off period, LICENSEE shall destroy or return to LICENSOR all remaining unsold PRODUCTS, all equipment used in the manufacture of the PRODUCTS, and all packaging and marketing materials, and shall certify their destruction or return to LICENSOR specifying the number of PRODUCTS destroyed or returned. All royalty obligations, including any unpaid portions of the minimum royalty, shall be accelerated and shall become immediately due and payable. In addition, LICENSEE shall immediately deliver to LICENSOR: (i) all materials relating to the PATENTS, together with all copies thereof, and (ii) all market studies or other tests or studies conducted by LICENSEE with respect to the

PRODUCTS, all at a cost to LICENSOR to be negotiated, but not to exceed LICENSEE's out-of-pocket costs to provide such materials.

d. LICENSEE acknowledges and agrees that any violation of this Agreement by LICENSEE would result in irreparable harm to LICENSOR. Accordingly, LICENSEE consents and agrees that, if LICENSEE violates any of the provisions of this Agreement, LICENSOR shall be entitled, in addition to other remedies available to it, to an injunction to be issued by any court of competent jurisdiction restraining LICENSEE from committing or continuing any violation of this Agreement.

15. NOTICES AND REPORTS; PAYMENTS

Any notice or report permitted or required under this Agreement shall be in writing, and all notices, reports, and payments shall be sent or delivered to the receiving party at the address set forth below or at such other address as either party may from time to time designate in writing. The parties may from time to time agree in writing to designate additional parties to receive notices under this paragraph, including SUBLICENSEES.

LICENSOR: _ _[*Name*]_ _
_ _[*Address*]_ _
Attn: _ _[*Name or title*]_ _

With copy to: _ _[*Name*]_ _
_ _[*Address*]_ _
LICENSEE: _ _[*Name*]_ _
_ _[*Address*]_ _

Attn: _ _[*Name or title*]_ _

With copy to: _ _[*Name*]_ _
_ _[*Address*]_ _

16. CONFIDENTIALITY

Notices, reports, and other information transmitted between the parties that is deemed confidential by the provider shall be held in confidence by the recipient as follows. The recipient shall protect the disclosed confidential information by using reasonable care to prevent the unauthorized use, dissemination, or publication of the confidential information. The recipient shall not disclose confidential information to any third party and shall limit disclosure to those of its employees, students, staff, or agents with a need to know, provided that the recipient shall have a duty to protect only that confidential information that is (a) disclosed by the discloser in writing and is marked as "confidential" at the time of disclosure, or that is (b) disclosed by the discloser in any other manner, is identified as confidential at the time of disclosure, and is also summarized and designated as confidential in a writing delivered to the recipient's contact named in Paragraph 15 above within _ _[*number, e.g., 15*]_ _ days of the disclosure. The recipient shall have no obligation with respect to confidential information that (a) was in the recipient's possession before receipt from the discloser; (b) is or becomes a matter of public knowledge through no fault of the recipient; (c) is rightfully received by the recipient from a third party without a duty of confidentiality; (d) is disclosed by the discloser to a third party without a duty of confidentiality on the third party; (e) is independently developed by the recipient; or (f) is available to the public under operation of law.

17. PARAGRAPH HEADINGS

Paragraph headings are for the convenience of this Agreement only and shall not add to or detract from any of the terms or provisions.

18. SEVERABILITY

If any provision of this Agreement is held invalid under any law applicable to LICENSOR, LICENSEE, any SUBLICENSEE, or any assignee, that provision shall be considered severable and its invalidity shall not affect the remainder of this Agreement, which shall continue in full force and effect.

19. CONTROLLING LAW, JURISDICTION, AND VENUE

This Agreement shall be deemed to be executed and to be performed in the State of California, and shall be construed in accordance with the laws of the State of California regarding all matters, including but not limited to matters of validity, construction, effect, and performance. In the event of any controversy, claim, or dispute between the parties arising out of or relating to this Agreement, such controversy, claim, or dispute shall be tried exclusively in the courts of the State of California or in the United States District Court for the _ _[*name of federal judicial district*]_ _ District of California, as either party may elect. Each of the parties hereby waives any defense of lack of in personam jurisdiction, improper venue, or forum non conveniens, and agrees that service of process of such court may be made on each of them by personal delivery or by mailing certified or registered mail, return receipt requested, to the other party at the address provided in Paragraph 15. Both parties hereby submit to the jurisdiction of the court so selected, to the exclusion of any other courts that may have had jurisdiction apart from this Paragraph 19.

20. TERM OF AGREEMENT

Except as otherwise terminated pursuant to the other provisions of this Agreement, this Agreement shall terminate on the later of: (a) the date of expiration of the last of the issued PATENTS, or (b) 15 years from the EFFECTIVE DATE of this Agreement.

21. NEGATION OF WARRANTIES

a. Nothing in this Agreement shall be construed as:

i. A warranty or representation by LICENSOR regarding the validity or scope of any PATENT; or

ii. A warranty or representation that any PRODUCTS made, used, sold, or otherwise disposed of under any license granted in this Agreement are or will be free from infringement of patents of third parties; or

iii. An obligation to bring or prosecute actions or suits against third parties for infringement; or

iv. Conferring the rights to use in advertising, publicity, or otherwise any trademark, trade name, or names, or any contraction, abbreviation, simulation, or adoption thereof, of LICENSOR or LICENSEE; or

v. Any obligation to furnish any know-how not provided under this Agreement.

b. LICENSOR MAKES NO EXPRESS OR IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE, nor does LICENSOR represent that the rights granted under this Agreement will result in PRODUCTS that are commercially successful.

c. LICENSEE further agrees that it will not rely on technical information provided by LICENSOR in developing and manufacturing any PRODUCTS under this Agreement, but will independently test, analyze, and evaluate all PRODUCTS before their manufacture and distribution.

22. INDEMNIFICATION

a. LICENSEE shall defend, indemnify, and hold harmless LICENSOR and its trustees, officers, medical and professional staff, employees, and agents, and their respective successors, heirs, and assigns (the "Indemnitees"), against all liabilities, demands, losses, costs, and expenses (including without limitation attorney fees) incurred by or imposed on the Indemnitees or any one of them in connection with any claims, suits, actions, demands, or judgments arising out of any theory of liability (including but not limited to actions in the form of tort, warranty, or strict liability) for death, personal injury, illness, or property damage arising from LICENSEE's use, sale, or other disposition of the PRODUCTS.

b. LICENSEE agrees, at its own expense, to provide attorneys reasonably acceptable to LICENSOR to defend against any actions brought or filed against any party indemnified under this Agreement with respect to the subject of indemnity contained herein, whether or not such actions are rightfully brought. To the extent that any proposed settlement directly affects LICENSOR, LICENSEE shall obtain LICENSOR's consent before finally agreeing to such settlement proposal, which consent shall not be unreasonably withheld.

23. INSURANCE

a. On execution of this Agreement, LICENSEE shall, at its sole cost and expense, procure and maintain in effect a comprehensive general liability policy of insurance in single limit coverage of not less than $_ _[*amount*]_ _ per incident and $_ _[*amount*]_ _ annual aggregate for death, bodily injury, or illness, and $_ _[*amount*]_ _ annual aggregate in property damage. Such comprehensive general liability insurance shall provide (i) product liability coverage and (ii) broad form contractual liability coverage for LICENSEE's indemnification. If LICENSEE elects to self-insure all or part of the limits described above (including deductibles or retention in excess of $_ _[*amount*]_ _ annual aggregate), such self-insurance program must be acceptable to LICENSOR. Each such policy of insurance shall name LICENSOR as an additional insured and shall provide for not less than _ _[*number, e.g., 30*]_ _ days' prior written notice before any cancellation or material change in coverage shall be effective. A certificate evidencing the comprehensive general liability policy required by this Paragraph 23.a shall be delivered to LICENSOR within _ _[*number, e.g., 10*]_ _ days after the EFFECTIVE DATE of this Agreement. LICENSEE shall maintain such comprehensive general liability insurance until the earlier of: (i) the time that the policy in Paragraph 23.b or Paragraph 23.c is procured, or (ii) _ _[*number, e.g., 15*]_ _ years after expiration of the term of this Agreement.

b. During such time and in each country where PRODUCT, or any modification thereof, is utilized in human clinical trials by LICENSEE or any SUBLICENSEE, LICENSEE shall, at its sole cost and expense, procure and maintain in effect a comprehensive general liability policy of insurance in single limit coverage of not less than $_ _[*amount*]_ _ per incident and $_ _[*amount*]_ _ annual aggregate for death, bodily injury, illness, or property damage. Such comprehensive general liability insurance shall provide (i) product liability coverage and (ii) broad form contractual liability coverage for LICENSEE's indemnification. If LICENSEE elects to self-insure all or part of the limits described above (including deductibles or retention in excess of $_ _[*amount*]_ _ annual aggregate) such self-insurance program must be acceptable to LICENSOR. Each such policy of insurance shall name LICENSOR as an additional insured and shall provide for not less than _ _[*number, e.g., 30*]_ _ days' prior written notice before any cancellation or material change in coverage shall be effective. A certificate evidencing the comprehensive general liability policy required by this Paragraph 23.b shall be delivered to LICENSOR before any manufacture, sale, distribution, or administration of the PRODUCT to humans. LICENSEE shall maintain such comprehensive general liability insurance until the earlier of: (i) the time that the policy in Paragraph 23.c is procured, or (ii) _ _[*number, e.g., 15*]_ _ years after expiration of the term of this Agreement.

c. During the time when and in each country where PRODUCT, or any modification thereof, is administered to humans, manufactured, or distributed for any purpose other than for human clinical trials as specified in Paragraph 23.b (including for the purpose of obtaining regulatory approvals) by LICENSEE or any SUBLICENSEE, LICENSEE shall at its sole cost and expense, procure and maintain in effect a comprehensive general liability policy of insurance in single limit coverage of not less than $_ _[*amount*]_ _ per incident and $_ _[*amount*]_ _ annual aggregate for death, bodily injury, illness, or property damage. Such comprehensive general liability insurance shall provide (i) product liability coverage and (ii) broad form contractual liability coverage for LICENSEE's indemnification. If LICENSEE elects to self-insure all or part of the limits described above (including deductibles or retention in excess of $_ _[*amount*]_ _ annual aggregate), such self-insurance program must be acceptable to LICENSOR. Each such policy of insurance shall name LICENSOR as an additional insured and shall provide for not less than_ _[*number, e.g., 30*]_ _ days' prior written notice before any cancellation or material change in coverage shall be effective. A certificate evidencing the comprehensive general liability policy herein defined shall be delivered to LICENSOR before any manufacture, sale, distribution, or administration to humans. LICENSEE shall maintain such comprehensive general liability insurance during the period that the PRODUCT or any modification thereof is being manufactured, sold, distributed, or administered to humans by the LICENSEE or its SUBLICENSEES and a reasonable period thereafter, which in no event shall be less than _ _[*number, e.g., 15*]_ _ years after expiration of the term of this Agreement.

d. In the event that LICENSEE does not maintain the insurance required by Paragraph 23.a through 23.c, but is self-insured or carries a substantial self-retention, LICENSOR may grant permission for such self-insurance only if, in the LICENSOR'S sole discretion, the net worth, assets, and earnings of the LICENSEE are deemed sufficient to protect LICENSOR's economic interests in the event of any claims, liability, demands, damages, expenses, or losses from death, personal injury, illness, or property damage.

e. The minimum amounts of insurance coverage required under Paragraphs 23.a, 23.b, and 23.c shall not be construed to create a limit of LICENSEE's liability with respect to its indemnification obligations in Paragraph 22 or any other provision of this Agreement.

f. LICENSEE shall include in the terms of any sublicense provisions obligating the SUBLICENSEE to indemnify LICENSEE and LICENSOR to the same extent and degree as LICENSEE has agreed to indemnify LICENSOR in this Agreement and to procure and maintain in effect, at all times during which the SUBLICENSEE manufactures, uses, sells, leases, or otherwise transfers or disposes of PRODUCTS and for a reasonable period of time thereafter, but in any event not less than _ _[*number, e.g., 15*]_ _ years, a comprehensive general liability policy of insurance having coverages no less that those specified in Paragraphs 23.a, 23.b and 23.c, naming both LICENSEE and LICENSOR as additional insureds. A certificate evidencing such comprehensive general liability policy shall be delivered to LICENSOR before LICENSOR may give permission for such sublicensing agreement, and a certificate evidencing the product liability coverage shall be delivered before first manufacture of any PRODUCTS by the SUBLICENSEE. In the event a prospective SUBLICENSEE does not maintain such insurance, but is self-insured, or carries a substantial self-retention, LICENSOR may grant permission for such sublicense only if, in the sole discretion of LICENSOR, the net worth, assets, and earnings of such prospective SUBLICENSEE are deemed sufficient to protect LICENSOR's economic interests in the event of any claims, liability, demands, damages, expenses, or losses from death, personal injury, illness, or property damage.

24. DAMAGES

NOTWITHSTANDING ANYTHING TO THE CONTRARY IN THIS AGREEMENT, TO THE MAXIMUM EXTENT PERMITTED BY LAW, IN NO EVENT SHALL EITHER PARTY BE RESPONSIBLE FOR ANY INCIDENTAL, CONSEQUENTIAL, INDIRECT, SPECIAL, PUNITIVE, OR EXEMPLARY DAMAGES OF ANY KIND, INCLUDING DAMAGES FOR LOST GOODWILL, LOST PROFITS, LOST BUSINESS, OR OTHER INDIRECT ECONOMIC DAMAGES, WHETHER SUCH CLAIM IS BASED ON CONTRACT, NEGLIGENCE, TORT (INCLUDING STRICT LIABILITY), OR OTHER LEGAL THEORY, AS A RESULT OF A BREACH OF ANY WARRANTY OR ANY OTHER TERM OF THIS AGREEMENT, AND REGARDLESS OF WHETHER A PARTY WAS ADVISED OR HAD REASON TO KNOW OF THE POSSIBILITY OF SUCH DAMAGES IN ADVANCE.

25. ATTORNEY FEES

In any action on or concerning this Agreement, the prevailing party shall be awarded its reasonable attorney fees, costs, and necessary disbursements, to be paid by the nonprevailing party.

26. PRODUCT DEVELOPMENT

LICENSEE shall use its reasonable efforts to test and develop the PRODUCT for commercial purposes throughout the world. On or before January 1 of each year during the term of this Agreement, commencing January 1, _ _[*year*]_ _, LICENSEE shall submit to LICENSOR a report, to be maintained in confidence according to Paragraph 16, detailing its research, regulatory approval, marketing, and product development objectives for the coming year, as well as the research, regulatory approval, marketing, and development activities that LICENSEE undertook during the preceding year. The reports shall identify specific future milestones (regulatory approval and product development) and information demonstrating that the LICENSEE is providing sufficient financial and manpower resources to evidence its use of reasonable efforts. Within _ _[*number, e.g., 6*]_ _ months after the EFFECTIVE DATE and each _ _[*number, e.g., 2*]_ _ years thereafter, a representative of LICENSOR on behalf of LICENSOR, at LICENSEE's expense (including transportation, and, if appropriate, lodging and meals), shall visit the manufacturing and marketing facilities of LICENSEE and be presented with an in-depth updating of LICENSEE's manufacturing capability and marketing network. LICENSEE is expected to pursue and achieve the following diligence-related milestones in the first _ _[*number, e.g., 3*]_ _ years following the EFFECTIVE DATE:

By end of Year 1: _ _[*Describe milestones*]_ _.

By end of Year 2: _ _[*Describe milestones*]_ _.

By end of Year 3: _ _[*Describe milestones*]_ _.

27. EXPORT CONTROLS

It is understood that LICENSOR is subject to U.S. laws and regulations controlling the export of technical data, computer software, laboratory prototypes, and other commodities, and that its obligations under this Agreement are contingent on compliance with applicable U.S. export laws and regulations. The transfer of

certain technical data and commodities by the LICENSEE may require either a license from the applicable agency of the U.S. government or written assurances by LICENSEE that LICENSEE shall not export data or commodities to certain foreign countries without prior approval of that agency. LICENSOR neither represents that a license will not be required nor that, if required, it will be issued. LICENSEE shall not engage in any activity in connection with this Agreement that is in violation of any applicable U.S. law.

28. INDEPENDENT CONTRACTOR

In rendering performances under this Agreement, LICENSEE shall function solely as an independent contractor and not as an agent, partner, employee, or joint venturer with LICENSOR. Nothing in this Agreement shall be deemed or construed to create the relationship of principal and agent, or to create a partnership or joint venture, and neither party shall hold itself out as an agent, legal representative, partner, subsidiary, joint venturer, servant, or employee of the other. Neither party nor any officer, employee, agent, or representative of a party shall, in any event, have any right, collectively or individually, to bind the other party, to make any representations or warranties, to accept service of process, to receive notice, or to perform any act or thing on behalf of the other party, except as expressly authorized under this Agreement or in writing by the other party in its sole discretion.

29. WAIVER

No waiver by either party of any default or breach shall be deemed to be a waiver of any prior or subsequent default or breach of the same or other provisions of this Agreement.

30. ENTIRE AGREEMENT

This Agreement constitutes the entire agreement between the parties concerning the subject matter hereof. No amendment, modification, extension, or cancellation of this Agreement shall be binding on the parties unless mutually agreed to and executed in writing by each of the parties.

EXECUTED on the dates set forth below, to be effective as of the EFFECTIVE DATE.

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSEE*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Appendix B

Sample Software License Agreement

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

SOFTWARE LICENSE AGREEMENT

THIS SOFTWARE LICENSE AGREEMENT (this "Agreement"), dated to be effective as of _ _[*date*]_ _ (the "EFFECTIVE DATE"), is between _ _[*name*]_ _ ("LICENSOR"), a _ _[*jurisdiction*]_ _ corporation, with its principal place of business at _ _[*address*]_ _, and _ _[*name*]_ _ ("LICENSEE"), a _ _[*jurisdiction*]_ _ corporation, with its principal place of business at _ _[*address*]_ _.

RECITALS

A. LICENSOR warrants that it is the owner and that it has the right to license the Software, Data, Documentation, and Web Services (as those terms are defined below);

B. LICENSEE desires to license, and LICENSOR is willing to grant a personal nonexclusive license to LICENSEE of, the Software, Data, Documentation, and Web Services, subject to the terms, conditions, limitations, and restrictions set forth in this Agreement.

AGREEMENT

NOW, THEREFORE, in consideration of the mutual promises contained in this Agreement, the parties agree as follows:

1. DEFINITIONS

The following capitalized terms have the meanings set forth below when used in this Agreement:

a. "Beta" means any alpha, beta, or prerelease Software, Data, Documentation, or Web Services.

b. "Data," except as otherwise provided herein, means any of LICENSOR's or any third party data vendor's digital data sets, including, but not limited to, geographic, vector data coordinates, raster, reports, or associated tabular attributes.

c. "Documentation" means all of the printed and digital materials including, but not limited to, help files, user reference documentation, training documentation, or technical information and briefings.

d. "Software" means the actual copy of all or any portion of LICENSOR's proprietary software technology, computer software code, components, dynamic link libraries (DLLs), underlying organization, object model, and programs delivered on any media, including any release provided in source, object, or executable code format(s), inclusive of backups, updates, service packs, patches, hot fixes, sample code, sample application, sample extension, or merged copies permitted hereunder.

e. "Web Services" means software services or third party data components that perform _ _[*identify*]_ _ functions, tasks, or data services and are accessed over the Internet.

2. INTELLECTUAL PROPERTY RIGHTS AND RESERVATION OF OWNERSHIP

The Software, Data, Web Services, and Documentation are licensed and not sold under this Agreement. LICENSOR and its licensors own the Software, Data, Web Services, and Documentation, which are protected by United States laws and applicable international laws, treaties, and conventions regarding intellectual property or proprietary rights, inclusive of trade secrets. From the date of receipt, LICENSEE agrees to use reasonable means to protect the Software, Data, Web Services, and Documentation from unauthorized use, reproduction, distribution, or publication. LICENSOR and its Licensors reserve all rights not specifically granted in this Agreement. LICENSOR and its third party data licensors reserve the right to improve or make changes in its offerings of the Web Services and its associated software, datasets, or information at any time.

3. GRANT OF LICENSE

3.1. *Grant of License.* Subject to the terms of this Agreement, LICENSOR grants to LICENSEE a personal, nonexclusive, nontransferable license to:

a. Use the type and number of copies of the Software, Data, and Documentation and access Web Services (i) for which the appropriate license fees have been paid to LICENSOR, (ii) for LICENSEE's own internal use only, and (iii) in accordance with Exhibit _ _ and the licensed configuration on file as authorized by LICENSOR.

b. Access and use any secure LICENSOR website resources made available to LICENSEE for LICENSEE's internal use only, provided that LICENSEE follows LICENSOR's terms of use policy specified therein. All password or controlled access information provided by LICENSOR shall be treated as LICENSOR confidential information.

3.2. *Beta Testing.* LICENSEE may be accepted into a current Beta testing program. LICENSEE may be provided copies of, or access to, Beta for the limited purpose of testing Beta in accordance with the Beta testing policies then in effect. Delivered Beta is confidential and proprietary to LICENSOR and contains trade secrets, inclusive of unpublished specifications. LICENSEE agrees to retain all Beta in confidence. Except for a public Beta testing program, LICENSEE shall maintain results of testing, performance statistics, errors, or any other quality issues encountered in confidence, and agrees not to disclose same to any third party. Beta is subject to change prior to its commercial release and may never be commercially released. LICENSEE acknowledges that such Beta is not suitable or licensed for full use and accepts all responsibility for use of the same and any results generated. LICENSEE may from time to time provide suggestions or comments regarding performance, usability or effectiveness, bug reports, test reports, or other feedback (collectively, "Feedback") to LICENSOR with respect to Beta. LICENSOR retains title to such comments and may freely use, disclose, reproduce, license, distribute, and otherwise commercialize any Feedback. A Beta testing program may have additional requirements.

3.3. *Limited Term Licenses.* LICENSOR may from time to time offer one or more limited term licenses for Software, Data, Web Services, or Documentation for LICENSEE's evaluation only.

3.4. *Consultant Access.* LICENSEE may provide access to the Software, Data, Web Services, or Documentation to any consultant or contractor of LICENSEE, provided that the consultant or contractor is using the Software, Data, Web Services, or Documentation exclusively for the benefit of LICENSEE. LICENSEE shall be responsible for compliance by consultants or contractors with the terms and conditions of this Agreement. LICENSEE shall require consultant or contractor to discontinue use of, and access to, Software, Data, Web Services, and Documentation on completion of work for LICENSEE.

4. SCOPE OF USE

4.1. Permitted Uses

a. LICENSEE may install and store copies of Software, Data, and Documentation onto electronic storage devices.

b. LICENSEE may make one copy of the Software, Data, and Documentation for archival purposes. LICENSEE may make routine computer backups.

c. LICENSEE may customize the Software using any (i) macro or scripting language, (ii) published application programming interface (API), or (iii) source or object code libraries, but only to the extent that such customization is described in the Documentation.

d. LICENSEE may use, copy, or prepare derivative works of the Documentation supplied in digital format and thereafter reproduce, display, and redistribute the customized documentation only for LICENSEE's own internal use. The portion(s) of the Documentation supplied in digital format merged with other software and printed or digital documentation shall continue to be subject to the terms and conditions of this Agreement and shall provide the following copyright attribution notice acknowledging the proprietary rights of LICENSOR and its Licensor(s) in the Documentation supplied in digital format: "Portions of this document include intellectual property of LICENSOR and its licensor(s) and are used herein under license. Copyright © _ _[*date(s)*]_ _ LICENSOR and its licensor(s). All rights reserved."

4.2. Uses Not Permitted

a. Except as provided herein, LICENSEE shall not sell, rent, lease, sublicense, lend, assign, or time-share the Software, Data, Web Services, or Documentation. LICENSEE shall not act as a service bureau or commercial Application Service Provider (ASP) that allows third party access to the Software, Data, Web

Services, and Documentation. A commercial ASP means a person or entity who uses Software, Data, Web Services, or Documentation for a site or service, and operates the site or the service for a profit, or generates revenue by charging for access to the site or service.

b. LICENSEE shall not redistribute the Software to third parties, in whole or in part, including, but not limited to, extensions, components, or DLLs, without the prior written approval of LICENSOR as set forth in an appropriate redistribution license agreement.

c. LICENSEE shall not reverse engineer, decompile, or disassemble the Software, Data, Web Services, or Documentation, except to the extent that such activity is expressly permitted by applicable law notwithstanding this restriction.

d. Except to the extent that applicable law prohibits this restriction, LICENSEE shall not make any attempt to circumvent the technological measures that controls access to, or use of, the Software, Data, Web Services, and Documentation.

e. LICENSEE shall not redistribute any Software registration number license authorization files, developer license files, or Web Services access codes.

f. LICENSEE shall not use the Software or Web Services to transfer or exchange any material where such transfer or exchange is prohibited by intellectual property laws or any other applicable laws.

g. LICENSEE shall not remove or obscure any of LICENSOR's or its licensors' patent, copyright, trademark, or proprietary rights notices contained in or affixed to the Software, Data, Web Services, or Documentation.

h. LICENSEE shall not unbundle individual or component parts of the Software or Data for independent use.

5. TERM AND TERMINATION

The license granted in this Agreement is effective on acceptance of this Agreement and shall continue until (i) such time that LICENSEE elects in writing to discontinue use of the Software, Data, Web Services, or Documentation and terminates the license; (ii) expiration of a term license or subscription; or (iii) either party terminates the license for a material breach that is not cured within 10 days of written notice to the other party, except that termination is immediate for a material breach of a nature that it is impossible to cure. On termination of a license, LICENSEE shall (i) cease access and use of Web Services and clear Web Services client-side data cache or (ii) uninstall, remove, and destroy all Software, Data, and Documentation, and any whole or partial copies, modifications, or merged portions in any form and execute and deliver evidence of such actions to LICENSOR.

6. LIMITED WARRANTIES AND DISCLAIMERS

6.1. *Limited Warranties.* For a period of _ _[*number, e.g., 90*]_ _ days from the date of receipt of Software authorization or keycode files by LICENSEE, LICENSOR warrants that (i) the unmodified Software will substantially conform to the published Documentation and (ii) the media on which the Software, Data, and Documentation is provided will be free from defects in materials and workmanship under normal use and service.

6.2. *Data and Web Services Disclaimer.* If included under this Agreement, the Data and Web Services have been obtained from sources believed to be reliable, but the accuracy and completeness of the Data and Web Services are not guaranteed. The Data and Web Services may contain some nonconformities, defects, errors, or omissions. LICENSOR AND ITS LICENSOR(S) MAKE NO WARRANTY WITH RESPECT TO THE DATA OR WEB SERVICES; THE DATA AND WEB SERVICES ARE PROVIDED "AS IS." Without limiting the generality of the preceding sentence, LICENSOR and its licensor(s) do not warrant that the Data or Web Services will meet LICENSEE's needs or expectations, that the use of the Data or Web Services will be uninterrupted, or that all nonconformities can or will be corrected. LICENSOR and its licensor(s) are not inviting reliance on the Data or Web Services, and LICENSEE should always verify actual Data or Web Services.

6.3. *Fault Tolerance Disclaimer*

a. The Software, Data, Web Services, and Documentation are not fault-tolerant and are not designed, manufactured, or intended for use or resale for use in insurance underwriting or with critical health and safety or online control equipment in hazardous environments that require fail-safe performance, such as in the operation of nuclear facilities, aircraft navigation, or communication systems, air traffic control, real-time emergency response, real-time terrorism prevention or response, life support, or weapons systems ("Fault-

Intolerant Activities"). LICENSOR SPECIFICALLY DISCLAIMS ANY EXPRESS OR IMPLIED WARRANTY OF FITNESS FOR USE IN FAULT-INTOLERANT ACTIVITIES.

b. To the extent permitted by law, LICENSEE agrees to indemnify, defend, and hold LICENSOR, its officers, directors, employees, agents, subcontractors, licensors, successors, and assigns harmless from and against any and all liability, losses, claims, expenses (including attorney fees), demands, or damages of any kind, including direct, indirect, special, punitive, incidental, or consequential damages, arising out of or in any way connected with LICENSEE's use or permitting the use by others of the Software, Web Services, and Data for Fault-Intolerant Activities. Delivery of the Software, Web Services, and Data does not constitute a waiver of the rights and obligations set forth in this Article.

6.4. *Special Disclaimer.* SAMPLE CODE, SAMPLE APPLICATION, SAMPLE EXTENSION, HOT FIXES, EVALUATION SOFTWARE, AND BETA ARE DELIVERED "AS IS" WITHOUT WARRANTY OF ANY KIND. LICENSEE ASSUMES ALL RISK AS TO THE QUALITY AND PERFORMANCE OF THE SAMPLE CODE, SAMPLE APPLICATION, SAMPLE EXTENSION, HOT FIXES, EVALUATION SOFTWARE, AND BETA.

6.5. *Internet Disclaimer.* BOTH PARTIES EXPRESSLY ACKNOWLEDGE AND AGREE THAT THE INTERNET IS A NETWORK OF PRIVATE AND PUBLIC NETWORKS, AND THAT (1) THE INTERNET IS NOT A SECURE INFRASTRUCTURE, (2) NEITHER PARTY HAS CONTROL OVER THE INTERNET, AND (3) NEITHER PARTY IS LIABLE FOR DAMAGES UNDER ANY THEORY OF LAW RELATED TO THE DISCONTINUANCE OF OPERATION OF ANY PORTION OF THE INTERNET OR POSSIBLE REGULATION OF THE INTERNET THAT MIGHT RESTRICT OR PROHIBIT THE OPERATION OF THE WEB SERVICES.

6.6. *General Disclaimer.* EXCEPT FOR THE ABOVE EXPRESS LIMITED WARRANTIES, LICENSOR DISCLAIMS ALL OTHER WARRANTIES OF ANY KIND, EITHER EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, THE IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, NONINTERFERENCE, SYSTEM INTEGRATION, AND NONINFRINGEMENT. LICENSOR DOES NOT WARRANT THAT THE SOFTWARE, DATA, WEB SERVICES, OR DOCUMENTATION WILL MEET LICENSEE'S NEEDS, OR THAT LICENSEE'S OPERATION OF THE SAME WILL BE UNINTERRUPTED OR ERROR FREE, OR THAT ALL NONCONFORMITIES CAN OR WILL BE CORRECTED.

6.7. *Exclusive Remedy.* LICENSEE's exclusive remedy and LICENSOR's entire liability for breach of the limited warranties set forth in this Article 6 shall be limited, at LICENSOR's sole discretion, to (i) replacement of any defective media; (ii) repair, correction, or a work-around for the Software subject to the LICENSOR Support Services Policy; or (iii) return of the license fees paid by LICENSEE for the Software or Documentation that does not meet LICENSOR's Limited Warranty, provided that LICENSEE uninstalls, removes, and destroys all copies of the Software or Documentation and executes and delivers evidence of such actions to LICENSOR.

7. LIMITATION OF LIABILITY

7.1. *Disclaimer of Certain Types of Liability.* LICENSOR AND ITS LICENSOR(S) SHALL NOT BE LIABLE TO LICENSEE FOR COSTS OF PROCUREMENT OF SUBSTITUTE GOODS OR SERVICES; LOST PROFITS; LOST SALES OR BUSINESS EXPENDITURES; INVESTMENTS; COMMITMENTS IN CONNECTION WITH ANY BUSINESS; LOSS OF ANY GOODWILL, OR FOR ANY INDIRECT, SPECIAL, INCIDENTAL, OR CONSEQUENTIAL DAMAGES ARISING OUT OF OR RELATED TO THIS AGREEMENT OR USE OF THE SOFTWARE, DATA, WEB SERVICES, OR DOCUMENTATION, HOWEVER CAUSED, ON ANY THEORY OF LIABILITY, AND WHETHER OR NOT LICENSOR OR ITS LICENSOR(S) HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGE. THESE LIMITATIONS SHALL APPLY NOTWITHSTANDING ANY FAILURE OF ESSENTIAL PURPOSE OF ANY LIMITED REMEDY.

7.2. *General Limitation of Liability.* EXCEPT AS PROVIDED IN ARTICLE 8—INFRINGEMENT INDEMNITY, LICENSOR'S TOTAL CUMULATIVE LIABILITY HEREUNDER, FROM ALL CAUSES OF ACTION OF ANY KIND, INCLUDING, BUT NOT LIMITED TO, CONTRACT, TORT (INCLUDING NEGLIGENCE), STRICT LIABILITY, BREACH OF WARRANTY, MISREPRESENTATION, OR OTHERWISE, SHALL NOT EXCEED THE AMOUNTS PAID TO LICENSOR BY LICENSEE FOR SOFTWARE, DATA, WEB SERVICES, OR DOCUMENTATION IN ACCORDANCE WITH THIS AGREEMENT.

7.3. *Applicability of Disclaimers and Limitations.* LICENSEE agrees that the limitations of liability and disclaimers set forth in this Agreement will apply regardless of whether LICENSEE has accepted the Software, Data, Web Services, or Documentation or any other product or service delivered by LICENSOR. The parties agree that LICENSOR has set its prices and entered into this Agreement in reliance on the disclaimers and limitations set forth herein, that the same reflect an allocation of risk between the parties (including the risk that a contract remedy may fail of its essential purpose and cause consequential loss), and that the same form an essential basis of the bargain between the parties.

8. INFRINGEMENT INDEMNITY

8.1. LICENSOR shall defend, indemnify, and hold harmless LICENSEE from and against any loss, liability, cost, or expense, including reasonable attorney fees, that may be incurred by LICENSEE against any claims, actions, or demands by a third party alleging that the Software, Data, or Documentation infringes a U.S. patent, copyright, or trademark provided

a. LICENSEE promptly notifies LICENSOR in writing of the claim thereof;

b. LICENSOR has sole control of the defense of any actions and negotiations related to the defense or settlement of any claim; and

c. LICENSEE cooperates fully in the defense of the claim.

8.2. If LICENSOR believes that the Software, Data, or Documentation is or will become the subject of an infringement claim, or in the event that use of the Software, Data, or Documentation is enjoined, LICENSOR, at its own expense, may either (i) obtain the right for LICENSEE to continue using the Software, Data, or Documentation or (ii) modify the Software, Data, or Documentation to make it noninfringing while maintaining substantially similar software functionality or data/informational content. If neither of such alternatives is commercially reasonable, the infringing items shall be returned to LICENSOR, the license shall terminate, and LICENSOR's sole liability shall be to indemnify LICENSEE in accordance with Article 8.1 and refund license fees paid by LICENSEE prorated on a _ _[*number, e.g., 5*]_ _ straight-line depreciation basis beginning from the initial date of delivery.

8.3. LICENSOR shall have no obligation hereunder to defend LICENSEE or to pay any resulting costs, damages, or reasonable attorney fees for or with respect to any claims, actions, or demands alleging (i) infringement that arises by reason of a combination of noninfringing items, however acquired, with any items not supplied by LICENSOR; (ii) infringement to the extent arising from material alteration of the Software, Data, or Documentation by anyone other than LICENSOR, its agents, or its contractors; (iii) the direct or contributory infringement of any process patent by LICENSEE through the use of the Software, Data, or Documentation other than a process patent that is necessarily infringed by the internal processes executed within the Software or Data itself when the Software or Data is executed for its intended purpose; (iv) continued allegedly infringing activity by LICENSEE after it has been notified of the possible infringement; or (v) continued allegedly infringing activity by LICENSEE to the extent it arises from failure of LICENSEE to use the updated or modified Software, Data, or Documentation provided by LICENSOR for avoiding infringement.

THE FOREGOING STATES THE ENTIRE OBLIGATION OF LICENSOR WITH RESPECT TO INFRINGEMENT OR ALLEGATION OF INFRINGEMENT OF INTELLECTUAL PROPERTY RIGHTS OF ANY THIRD PARTY.

9. GENERAL PROVISIONS

9.1. *Future Orders.* All Software, Data, Web Services, Documentation, or maintenance orders placed within 1 year of this Agreement's execution date shall be licensed under the terms of this Agreement, except that new Software, Data, Web Services, and Documentation commercially released during that year may require additional terms. Orders placed and Software, Data, Web Services, and Documentation or updates provided after that time shall be governed by the then-current General License Terms and Conditions and Exhibit _ _, the terms of which shall be indicated on LICENSOR's Web site, included with a quote, or included with the deliverable Software, Data, Web Services, or Documentation.

9.2. *Export Control Regulations.* LICENSEE expressly acknowledges and agrees that LICENSEE shall not export, reexport, or provide the Software, Data, Web Services, or Documentation, in whole or in part, to (i) any country to which the United States has embargoed goods; (ii) any person on the U.S. Treasury Department's list of Specially Designated Nationals; (iii) any person or entity on the U.S. Commerce Department's Table of Denial Orders; or (iv) any person or entity where such export, reexport, or provision violates any U.S. export control laws or regulations including amendments and supplemental additions as they may occur from time to time. LICENSEE shall not export the Software, Data, Web Services, and/or Documentation or any underlying information or technology to any facility in violation of these or other applicable laws and regulations including, but not limited to, the terms of any export license or licensing provision. LICENSEE represents and warrants that it or its employees, consultants, or customers who gain access to the Software, Data, Web Services, or Documentation are not a national, resident, located in or under the control of, or acting on behalf of any person, entity, or country subject to such U.S. export controls.

9.3. *Taxes and Fees; Shipping Charges.* License fees quoted to LICENSEE are exclusive of any and all taxes or fees including, but not limited to, sales tax, use tax, value-added tax (VAT), customs, duties, or tariffs, and shipping and handling charges.

9.4. *No Implied Waivers.* The failure of either party to enforce any provision of this Agreement shall not be deemed a waiver of the provisions or of the right of such party thereafter to enforce that or any other

provision.

9.5. *Severability.* The parties mutually agree that if any provision of this Agreement is held to be unenforceable for any reason, such provision shall be reformed only to the extent necessary to make the intent of the language enforceable.

9.6. *Counterparts.* This Agreement may be executed in counterparts, all of which, taken together, shall be deemed one (1) original document.

9.7. *Successor and Assigns.* LICENSEE shall not assign, sublicense, or transfer LICENSEE's rights or delegate its obligations under this Agreement without LICENSOR's prior written consent, and any attempt to do so without consent shall be void. This Agreement shall be binding on the respective successors and assigns of the parties to this Agreement. Notwithstanding, a Government contractor that has acquired Software, Data, Web Services, or Documentation under contract to the Government may assign its rights under this Agreement to its Government customer on written notice to LICENSOR provided the Government customer assents to the terms of this Agreement.

9.8. *Survival of Terms.* The provisions of Articles 2, 5, 6, 7, 8, and 9 of this Agreement shall survive the expiration or termination of this Agreement.

9.9. *Equitable Relief.* LICENSEE agrees that any breach of this Agreement by LICENSEE may cause irreparable damage and that, in the event of such breach, in addition to any and all remedies at law, LICENSOR shall have the right to seek an injunction, specific performance, or other equitable relief in any court of competent jurisdiction without the requirement of posting a bond or undertaking or proving injury as a condition for relief.

9.10. *Government License.* The Software, Data, Web Services, and Documentation are commercial computer software, commercial data, commercial computer software documentation, and commercial Web Services. This Agreement contains LICENSOR's commercial license terms and conditions for such items. The commercial license rights in this Agreement strictly govern LICENSEE's use, reproduction, or disclosure of the Software, Data, Web Services, and Documentation. No other license terms or conditions shall apply unless expressly agreed in writing by LICENSOR and LICENSEE. LICENSOR Software source code is unpublished and all rights to the Software, Data, Web Services, and Documentation are reserved under copyright laws of the United States. In the event any court, arbitrator, or board holds that the LICENSEE has greater rights to any portion of the Software, Data, Web Services, or Documentation under applicable public procurement law, such rights shall extend only to the portions affected, and use, duplication, or disclosure by the LICENSEE is subject to restrictions as provided in the applicable federal government procurement regulations (or the applicable local, state, or foreign equivalent).

9.11. *Governing Law; Arbitration*

a. For licensees in the United States of America, Its Territories, and Outlying Areas, this Agreement shall be governed by and construed in accordance with the laws of the State of California without reference to conflict of laws principles. Except as provided in Article 9.9, any dispute arising out of or relating to this Agreement, or the breach thereof, which cannot be settled through negotiation, shall be finally settled by arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules. Judgment on the award rendered by the arbitrator may be entered in a court of competent jurisdiction.

b. For all other licensees, except as provided in Article 9.9, any dispute arising out of, or relating to, this Agreement or the breach thereof, which cannot be settled through negotiation, shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one arbitrator appointed in accordance with said Rules. The language of the arbitration shall be in English. The place of the arbitration shall be at a mutually agreed location. This Agreement shall not be governed by the United Nations Convention on Contracts for the International Sale of Goods, the application of which is expressly excluded. Either party shall, at the request of the other, make available documents or witnesses relevant to the major aspects of the dispute.

9.12. *Independent Contractor.* In rendering performances under this Agreement, LICENSEE shall function solely as an independent contractor and not as an agent, partner, employee, or joint venturer with LICENSOR. Nothing in this Agreement shall be deemed or construed to create the relationship of principal and agent, or to create a partnership or joint venture, and neither party shall hold itself out as an agent, legal representative, partner, subsidiary, joint venturer, servant, or employee of the other. Neither party nor any officer, employee, agent, or representative of a party shall, in any event, have any right, collectively or individually, to bind the other party, to make any representations or warranties, to accept service of process, to receive notice, or to perform any act or thing on behalf of the other party, except as expressly authorized under this Agreement or in writing by the other party in its sole discretion.

9.13. *Waiver.* No waiver by either party of any default or breach shall be deemed to be a waiver of any prior or subsequent default or breach of the same or other provisions of this Agreement.

9.14. *Entire Agreement.* This Agreement constitutes the entire agreement between the parties concerning the subject matter hereof. No amendment, modification, extension, or cancellation of this Agreement shall be binding on the parties unless mutually agreed to and executed in writing by each of the parties.

EXECUTED on the dates set forth below, to be effective as of the EFFECTIVE DATE.

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF LICENSEE*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Appendix C

Sample Trademark License Agreement

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TRADEMARK LICENSE AGREEMENT

THIS TRADEMARK LICENSE AGREEMENT (this "Agreement"), dated to be effective _ _[*date*]_ _ (the "Effective Date"), is between _ _[*name*]_ _, a _ _[*jurisdiction*]_ _ corporation ("Licensor"), having an address at _ _[*address*]_ _, and _ _[*name*]_ _, a _ _[*jurisdiction*]_ _ corporation ("Licensee"), having an address at _ _[*address*]_ _.

RECITALS

Licensor is the exclusive owner of the trademarks and related designs as shown in Exhibit A attached hereto;

Licensee desires a license to use Licensor's trademarks and related designs in connection with the products listed in Exhibit B attached hereto in the geographic area specified below.

AGREEMENT

NOW THEREFORE, for and in consideration of the mutual promises set forth in this Agreement, and for other good and valuable consideration, Licensor and Licensee agree as follows:

1. DEFINITIONS

1.1. The term "Licensed Marks" means Licensor's trademark(s), service marks, trade names and related designs, logographics, and symbols, including, but not limited to, those shown in Exhibit A, those provided separately by Licensor, and any derivative art made by Licensee.

1.2. The term "Licensed Products" means any product or part thereof bearing one or more Licensed Marks listed in Exhibit B, and any packaging, advertising, or print materials bearing one or more of the Licensed Marks, but no other products or parts thereof.

1.3. The term "Net Sales Price" shall mean the Licensee's aggregate gross price, including the royalty amount, charged to customers for the Licensed Products, less quantity discounts, returns, and allowances, and any other deductions for cash or other discounts as listed on Licensee's invoices. No costs incurred in the manufacture, sale, distribution, or promotion of the Licensed Products shall be deducted in computing Net Sales Price except as specified above.

2. GRANT OF LICENSE

2.1. Subject to the terms of this Agreement and to the extent permitted by law, Licensor hereby grants Licensee a limited revocable nonexclusive license, without the right to sublicense, to use the Licensed Marks, and to make and use certain derivative works thereof on the Licensed Products listed in Exhibit B, in the United States of America.

2.2. Licensee shall not assign or sublicense the rights granted under this license.

2.3. Licensee shall not export Licensed Products outside the United States of America without the prior written consent of Licensor.

2.4. Subject to the terms of this Agreement, Licensee has the right to authorize manufacturers to produce Licensed Products, provided that such authorization is limited to producing Licensed Products for Licensee only. Licensee shall be responsible for ensuring that the Licensed Products produced by the manufacturers and any actions undertaken by the manufacturers satisfy all the requirements of this Agreement. Licensee assumes all responsibility for any actions undertaken by manufacturers relating to the use of the Licensed Marks and the manufacture, sale, or distribution of the Licensed Products. As a condition of this Agreement, Licensee shall provide to Licensor a current list of corporate names, addresses, and contacts of all factories and manufacturers involved in the production, manufacture, or sale of all Licensed Products. This list shall be updated annually, on the anniversary date of the Agreement.

[*If desired, add the following.*
See generally http://www.fairlabor.org.]

Additionally, as a condition of this License, Licensee shall provide a written statement of compliance with the Fair Labor Association Code of Conduct, attached as Exhibit C, and shall provide evidence of participation in and compliance with FLA procedures annually, on the anniversary date of this Agreement.

[*Continue*]

3. LICENSED PRODUCTS

3.1. Licensee shall submit samples of Licensed Products and artwork and depictions of all proposed uses of the Licensed Marks to Licensor at no cost, for approval prior to any use, sale, or other distribution to the public. Licensor shall review and approve or disapprove the product, the graphics, and designs depicting the Licensed Marks, and product packaging and designs in writing within _ _[*number, e.g., 15*]_ _ days of receipt thereof; provided, however, that if Licensor fails to approve or disapprove any proposed product or design within that time period, those items shall be deemed disapproved.

3.2. Licensee agrees that any proposed change by Licensee involving any alteration in the structure, design, or quality of the Licensed Products, or any change in the use of Licensed Marks, shall be submitted to Licensor for approval.

3.3. Licensee agrees that all Licensed Products manufactured and sold by it will be the same or substantially identical in quality and appearance to the initial samples approved by Licensor. Licensee shall maintain such reasonable manufacturing, servicing, and quality standards to ensure that all Licensed Products are consistent with such initial samples. Licensor or its duly authorized representatives have the right to inspect the premises of Licensee during all reasonable hours of operation during the term of this Agreement, including the time provided for disposition of inventory following termination of the Agreement, to ensure that standards of quality, as reflected in the approved samples of Licensed Products, are being maintained. From time to time, at the request of Licensor, Licensee shall submit to Licensor samples of the Licensed Products that Licensee is selling, so that Licensor may determine compliance with the terms of this Agreement.

4. ROYALTIES

4.1. As consideration for this license, Licensee agrees to pay Licensor a royalty of _ _[*number, e.g., 8*]_ _ percent of the Net Sales Price of all Licensed Products sold. Licensed Products shall be deemed to have been sold when invoiced, or if not invoiced, when they are paid for or when title passes to buyer, whichever is first. This royalty is payable by Licensee even if it does not charge the buyer for the Licensed Products and shall be based on the usual Net Sales Price charged to other buyers in the same or similar locality.

4.2. All royalties shall be paid quarterly within _ _[*number, e.g., 30*]_ _ days following the end of each calendar quarter. Payments shall be in April, July, October, and January for each preceding 3 months' sales.

4.3. On signing this Agreement and at the anniversary date of the Agreement, Licensee shall pay an Annual Minimum Guaranteed Royalty of $_ _[*amount*]_ _ for each calendar year in which this Agreement is in effect. Quarterly royalties due Licensor shall be credited against the Annual Minimum Guaranteed Royalty for the calendar year in which those royalties are earned.

4.4. In the event of default in payment of any royalties due Licensor under this Agreement, and if it becomes necessary for Licensor to undertake legal action to collect such royalties, Licensee shall pay for all reasonable legal fees and costs incurred by Licensor in connection therewith if the legal action undertaken by

Licensor results in a determination that royalties were due Licensor under the terms of this Agreement.

5. ACCOUNTS AND REPORTING

5.1. On or before the last day of April, July, October, and January of each year, Licensee shall furnish Licensor with a statement reporting total sales of Licensed Products bearing Licensed Marks for the preceding calendar quarter, with a calculation of royalties owed for those sales. If no sales or other uses of the Licensed Products were made during any reporting period, a statement to that effect shall be provided to Licensor by Licensee. On request of Licensor, Licensee shall provide certification with respect to the accuracy of such statement signed by a financial officer of Licensee.

5.2. Licensee shall keep account books and records showing the manufacture and sale or other distribution of Licensed Products. Such books and records shall be maintained for a period of at least _ _[*number, e.g., 3*]_ _ years after the payment of the corresponding royalty and shall be available for inspection by Licensor or a duly authorized representative of Licensor during normal business hours.

6. USE OF LICENSED MARKS

6.1. Licensee agrees that in the exercise of its rights under this Agreement, it will not state or imply either directly or indirectly that Licensee or Licensee's activities, other than those required by this Agreement, are supported, endorsed, or sponsored by Licensor. Licensee also agrees not to use the name of Licensor in its business or affairs other than in the performance of its rights and obligations under this Agreement.

6.2. Licensee agrees that it will not alter, modify, dilute, or otherwise misuse the Licensed Marks, or bring them into disrepute.

6.3. Licensee agrees not to use any other trademark, service mark, trade name, logo, symbol, or device in combination with any Licensed Marks without the prior written consent of Licensor.

6.4. Licensee shall, on request of Licensor, cause to appear on or within each product sold under this Agreement, by means of a tag, label, imprint, or other appropriate device, such copyright, trademark, or service mark notices as Licensor may from time to time designate.

6.5. Licensee recognizes the great value of the publicity and goodwill associated with the Licensed Marks and acknowledges that such goodwill belongs exclusively to Licensor. Licensee acknowledges Licensor's exclusive right, title, and interest in and to the Licensed Marks, and shall not in any manner represent that it has any ownership therein or in any registration thereof, and shall not knowingly in any way do or cause to be done any act or thing contesting or in any way impairing any part of the Licensor's right, title, and interest. Licensee agrees that, except for the rights granted herein, it has no interest in or ownership of the Licensed Marks, and further agrees not to register or attempt to register any of the Licensed Marks in any jurisdiction.

7. INDEMNIFICATION

Licensor assumes no liability to Licensee or third parties with respect to the performance characteristics of the Licensed Products manufactured or sold by Licensee. Licensee agrees to indemnify and hold harmless Licensor, its directors, officers, employees, and agents from any and all claims, demands, actions, causes of action, suits, damages, liabilities, costs, and expenses of every nature, including attorney fees, relating to or arising out of the manufacture, sale, or use of the Licensed Products or from the use of the Licensed Marks on such products. This indemnification shall include, but is not limited to, any and all claims or suits for which either party is alleged or found to have been wholly or partially negligent.

8. INSURANCE

Licensee shall maintain in effect insurance for both bodily injury and property damage liability, including product liability, in per occurrence limits of not less than $_ _[*amount, e.g., 1,000,000*]_ _. Such coverage shall be provided with respect to all claims for damages arising out of the manufacture, sale, or use of the Licensed Products, regardless of when such claims are made or when the underlying injuries occur or manifest themselves. Policies maintained by Licensee shall include an endorsement naming Licensor as additionally insured insofar as this Agreement is concerned, and shall provide that notice shall be given to Licensor at

least _ _[*number, e.g., 30*]_ _ days prior to cancellation or material reduction in the form of such policies. Copies of certificates as evidence of said insurance shall be delivered by Licensee to Licensor within _ _[*number, e.g., 15*]_ _ days after execution of this Agreement.

9. METHODS OF TERMINATION

9.1. Except as otherwise provided, this Agreement shall terminate automatically at the end of the term specified in Section 16.

9.2. This Agreement and all rights hereby granted may be revoked and terminated at any time by either party without cause on _ _[*number, e.g., 60*]_ _ days' written notice to the terminated party.

9.3. Should Licensee fail to comply with any provision of this Agreement, Licensor may terminate this Agreement on _ _[*number, e.g., 30*]_ _ days' written notice; provided, however, that such notice shall be void and of no effect if Licensee corrects such default during the 30-day notice period.

9.4. Termination of this Agreement shall not impair any accrued rights of Licensor.

10. EFFECTS OF TERMINATION

On termination of this Agreement, all rights granted to Licensee hereunder shall revert to Licensor, and Licensee shall make no claims to such rights.

11. LICENSEE'S DUTIES ON TERMINATION

11.1. On termination of this Agreement, Licensee agrees to immediately discontinue (1) the manufacture of all Licensed Products bearing the Licensed Marks, and (2) the use of the Licensed Marks; provided, however, that Licensee shall have the right to complete all Licensed Products bearing the Licensed Marks then in process and to dispose of its stock of all Licensed Products bearing the Licensed Marks that meet the standards of quality required by this Agreement at its normal Net Sales Price within _ _[*number, e.g., 3*]_ _ months after termination of this Agreement. Such disposition shall be subject to the terms of this Agreement including, but not limited to, those requiring reports of sales and payment of royalties. After such _ _[*number, e.g., 3*]_ _-month period, Licensee agrees to destroy all unsold Licensed Products bearing the Licensed Marks and to report to Licensor the number of each destroyed.

11.2. Notwithstanding the provisions of Section 11.1, Licensee's right to dispose of its stock after termination of this Agreement is subject to the condition that within _ _[*number, e.g., 30*]_ _ days after termination, Licensee (1) pays to Licensor all royalties accrued to the time of termination, and (2) delivers to Licensor a report of sales up to the time of termination in the form required by Section 5.1, and (3) provides Licensor with an inventory of unsold Licensed Products bearing Licensed Marks remaining and allows Licensor at its option to conduct a physical inventory to verify such a statement.

12. REMEDIES

Licensee acknowledges that its breach of this Agreement will result in immediate and irremediable damage to Licensor, and that money damages alone would be inadequate to compensate Licensor. Therefore, in the event of a breach or threatened breach of any provision of this Agreement by Licensee, Licensor may, in addition to all other remedies, immediately obtain and enforce injunctive relief prohibiting the breach or compelling specific performance.

13. SEVERABILITY

Should any provision of this Agreement be held unenforceable or in conflict with the law of any jurisdiction, then the validity of the remaining provisions shall not be affected by such a holding.

14. MODIFICATION AND WAIVER

14.1. The Parties agree that this Agreement may be modified from time to time by means of a written document signed by both Parties.

14.2. It is agreed that no waiver by either Party hereto of any breach of any of the provisions of this Agreement shall be deemed a waiver of any subsequent or similar breach.

15. ASSIGNABILITY

This Agreement shall inure to the benefit of Licensor, its successors and assigns, but shall be personal to Licensee. This Agreement shall be assignable by Licensee only with the prior written consent of Licensor.

16. TERM OF AGREEMENT

This Agreement shall continue in full force and effect from the Effective Date until _ _[*number, e.g., 2*]_ _ years from Effective Date, unless otherwise terminated by operation of law or by the acts of the Parties in accordance with the terms of this Agreement; provided, however, that Licensee is in compliance with all terms of the Agreement, including Sections 2.4, 4.3, and 8.

17. GOVERNING LAW

This Agreement shall be governed by and construed in accordance with the laws of the State of California and applicable federal law.

18. NOTICES AND PAYMENTS

Any notices and payments required by this Agreement shall be deemed to have been properly received when delivered in person or by courier service or when mailed by first class mail to the addressees given below, or such other addressees as may be designated from time to time during the term of this Agreement:

To Licensor:

_ _[*Name*]_ _
_ _[*Address*]_ _

To Licensee:

_ _[*Name*]_ _
_ _[*Address*]_ _

19. NO PARTNERSHIP OR FRANCHISE

This Agreement does not constitute and shall not be construed to constitute (1) a partnership or joint venture between Licensor and Licensee, or (2) a franchise agreement between Licensor and Licensee. Licensee shall have no right to obligate or bind Licensor in any manner whatsoever, and nothing contained in this Agreement shall give or is intended to give any rights of any kind to third persons.

20. ENTIRE AGREEMENT

This Agreement contains the entire agreement between the Parties with regard to the subject matter hereof and supersedes all other statements and representations pertaining to this subject matter.

EXECUTED on the dates set forth below, to be effective as of the Effective Date.

Date: _ _ _ _ _ _ _ _[*NAME OF LICENSOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ _ _[*NAME OF LICENSEE*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

EXHIBIT A

TRADEMARK SAMPLES

EXHIBIT B

LICENSED PRODUCTS

[*Add Exhibit C if referenced in Section 2.4.*
See generally http://www.fairlabor.org]

EXHIBIT C

THE FAIR LABOR ASSOCIATION
WORKPLACE CODE OF CONDUCT

Forced Labor

There shall not be any use of forced labor, whether in the form of prison labor, indentured labor, bonded labor or otherwise.

Child Labor

No person shall be employed at an age younger than 15 (or 14 where the law of the country of manufacture allows*) or younger than the age for completing compulsory education in the country of manufacture where such age is higher than 15.

Harassment or Abuse

Every employee shall be treated with respect and dignity. No employee shall be subject to any physical, sexual, psychological or verbal harassment or abuse.

Nondiscrimination

No person shall be subject to any discrimination in employment, including hiring, salary, benefits, advancement, discipline, termination or retirement, on the basis of gender, race, religion, age, disability, sexual orientation, nationality, political opinion, or social or ethnic origin. Health and Safety Employers shall provide a safe and healthy working environment to prevent accidents and injury to health arising out of, linked with, or occurring in the course of work or as a result of the operation of employer facilities.

Freedom of Association and Collective Bargaining

Employers shall recognize and respect the right of employees to freedom of association and collective bargaining.

Wages and Benefits

Employers recognize that wages are essential to meeting employees' basic needs. Employers shall pay employees, as a floor, at least the minimum wage required by local law or the prevailing industry wage, whichever is higher, and shall provide legally mandated benefits.

Hours of Work

Except in extraordinary business circumstances, employees shall (i) not be required to work more than the lesser of (a) 48 hours per week and 12 hours overtime or (b) the limits on regular and overtime hours allowed by the law of the country of manufacture or, where the laws of such country do not limit the hours of work, the

regular work week in such country plus 12 hours overtime and (ii) be entitled to at least one day off in every seven-day period.

Overtime Compensation

In addition to their compensation for regular hours of work, employees shall be compensated for overtime hours at such premium rate as is legally required in the country of manufacture or, in those countries where such laws do not exist, at a rate at least equal to their regular hourly compensation rate.

Any Company that determines to adopt the Workplace Code of Conduct shall, in addition to complying with all applicable laws of the country of manufacture, comply with and support the Workplace Code of Conduct in accordance with the Principles of Monitoring and shall apply the higher standard in cases of differences or conflicts. Any Company that determines to adopt the Workplace Code of Conduct also shall require its licensees and contractors and, in the case of a retailer, its suppliers to comply with applicable local laws and with this Code in accordance with the Principles of Monitoring and to apply the higher standard in cases of differences or conflicts.

***All references to local law throughout this Code shall include regulations implemented in accordance with applicable local law.**

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Appendix D

Sample Secured Lending Documents

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D-1 Patent Collateral Security and Pledge Agreement

D-2 Trademark Collateral Security and Pledge Agreement

D-3 Copyright and Trade Secret Collateral Security Agreement

D-4 Software Escrow Agreement

D-5 Provisions for Additional Secured Party Rights Relating to Intellectual Property on Default

D-6 Intellectual Property Representations and Warranties from Loan and Security Agreement

D-7 Intellectual Property Covenants from Loan and Security Agreement

D-8 Power of Attorney Provisions

D-9 Patent and Trademark Transfer Statement

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Appendix D-1

Patent Collateral Security and Pledge Agreement

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To download **WordPerfect** version, right click and choose *Save Target As*

PATENT COLLATERAL SECURITY AND PLEDGE AGREEMENT

This PATENT COLLATERAL SECURITY AND PLEDGE AGREEMENT, dated as of _ _[*date*]_ _ (as it may be amended, restated, supplemented, or otherwise modified from time to time, this "Agreement"), is made by each of the signatories hereto (collectively, the "Grantors") in favor of _ _[*name*]_ _, as administrative agent (in such capacity, the "Administrative Agent") for the First Lien Secured Parties and the Second Lien Secured Parties (each such term as defined in the Credit Agreement referred to below).

RECITALS

A. _ _[*Name*]_ _, a _ _[*e.g., California corporation*]_ _ ("Borrower 1"), and _ _[*name*]_ _, a _ _[*e.g., California corporation*]_ _ ("Borrower 2" and, together with Borrower 1, the "Borrowers"), have entered into a Credit Agreement, dated as of _ _[*date*]_ _ (as amended, supplemented, or otherwise modified from time to time, the "Credit Agreement"), with the banks and other financial institutions and entities from time to time party thereto (the "Lenders"); the Sole Lead Arranger and Sole Book Manager; and the Administrative Agent. Capitalized terms used and not defined herein have the meanings given such terms in the Credit Agreement.

B. It is a condition precedent to the obligation of the Lenders to make their respective extensions of credit to the Borrowers under the Credit Agreement that the Grantors shall have executed and delivered that certain Guarantee and Collateral Agreement, dated as of _ _[*date*]_ _, in favor of the Administrative Agent (as amended, supplemented, replaced, or otherwise modified from time to time, the "Guarantee and Collateral Agreement").

C. Under the terms of the Guarantee and Collateral Agreement, the Grantors have granted a security interest in certain Property, including, without limitation, certain Intellectual Property of the Grantors, to the Administrative Agent for the ratable benefit of the Secured Parties, and have agreed as a condition thereof to execute this Agreement for recording with the United States Patent and Trademark Office and other applicable Governmental Authorities.

D. This Agreement is supplemental to the provisions contained in the Guarantee and Collateral Agreement and the Credit Agreement and, in the event of an inconsistency among them, the Credit Agreement shall control over the Guarantee and Collateral Agreement and the Guarantee and Collateral Agreement shall control over this Agreement.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Grantors agree as follows:

1. DEFINITIONS

1.1. Terms Defined in the Credit Agreement and the Guarantee and Collateral Agreement. All capitalized terms used in this Agreement and not otherwise defined in this Agreement shall have the meanings assigned to them in the Credit Agreement and the Guarantee and Collateral Agreement.

1.2. Certain Defined Terms. As used in this Agreement, the following terms shall have the following meanings:

"Assignment of Patents" has the meaning set forth in Section 2.1.

"Issued Patents" means any and all past, present, or future federal, state, local, and foreign issuances of the Patents, including, but not limited to, those set forth on Schedule A, all past, present, and future applications for any such issuances (and any such issuances thereof on approval of such applications), together with the right (but not the obligation) to apply for such registrations (and prosecute such applications) in the name of any Grantor or the Administrative Agent, and to take any and all actions necessary or appropriate to maintain such registrations in effect and renew and extend such registrations.

"Patent Applications" means all past, present, or future applications in the name of any Grantor or in which the Grantor has a claim of ownership.

"Patent Collateral" has the meaning set forth in Section 2.1.

"Patent Rights" means any and all past, present, or future rights in, to, and associated with the Patents throughout the world, whether arising under federal law, state law, common law, foreign law, or otherwise, including the following: all such rights arising out of or associated with the Issued Patents, Patent Applications, and unfiled patents; all licenses relating to any of the Patents and all income and royalties with respect to any licenses (including, but not limited to, such Issued Patents and Patent Applications as described in Schedule A); the right (but not the obligation) to register claims under any state, federal, or foreign patent law or regulation; the right (but not the obligation) to sue in the name of any Grantor or the Administrative Agent for any and all past, present, and future infringements of or any other damages or injury to the Patents, and the rights to damages or profits due or accrued arising out of or in connection with any such past, present, or future infringement, damage, or injury.

"Patents" means all of the Issued Patents, Patent Applications, or unfiled patents used or associated with or appurtenant to the products, services, and businesses of each Grantor in which such Grantor now has or in the future acquires any right, title, or interest.

"PTO" means the United States Patent and Trademark Office.

1.3. Rules of Interpretation. Unless otherwise provided herein, the rules of interpretation set forth in Section ____ of the Credit Agreement shall be applicable to this Agreement.

2. GRANT OF SECURITY INTEREST

2.1. Security Interest for First Lien Secured Parties. It being expressly understood and agreed that the security interests granted herein for the benefit of the Administrative Agent on behalf of the applicable Secured Parties shall be subject to the provisions of the Intercreditor Agreement, as collateral security for the payment and performance in full of all of the First Lien Obligations, each Grantor hereby grants to the Administrative Agent, for the benefit of the Administrative Agent and the ratable benefit of the First Lien Secured Parties, a continuing security interest in and first priority lien on all of such Grantor's rights, title, and interests in all Patents, Patent Applications, Issued Patents, and Patent Rights, in each case whether now or hereafter existing or arising or in which such Grantor now has or hereafter owns, acquires, or develops an interest and wherever located (collectively, the "Patent Collateral"). Notwithstanding the foregoing provisions of this Section 2.1, the Patent Collateral shall not include, and no Grantor shall hereby be deemed to grant a security interest in, (i) any rights of such Grantor under any license, lease, agreement, or contract existing as of the Effective Date that expressly prohibits any such security interest (other than in respect of the right to receive money due or to become due under such excluded license, lease, agreement, or contract) or (ii) any equipment, inventory, accounts, or fixtures that are subject to any Lien permitted under Section ____ of the Credit Agreement to the extent, but only to the extent, that the documents creating any such Lien expressly prohibit the grant of any such security interest; *provided*, *however*, that in the event that any such prohibition may be waived or avoided on any Grantor's obtaining a consent to such security interest or through the satisfaction of any other condition precedent and such consent is obtained or such condition precedent is satisfied, the foregoing provisions of this sentence shall not be effective with respect to such license, lease, agreement, contract, or Lien.

2.2. Security Interest for Second Lien Secured Parties. It being expressly understood and agreed that the security interests granted herein for the benefit of the Administrative Agent on behalf of the applicable Secured Parties shall be subject to the provisions of the Intercreditor Agreement, as collateral security for the payment

and performance in full of all of the Second Lien Obligations, each Grantor hereby grants to the Administrative Agent, for the benefit of the Administrative Agent and the ratable benefit of the Second Lien Secured Parties, a continuing security interest in and second priority lien on all of such Grantor's rights, title, and interests in all Patents, Patent Applications, Issued Patents, and Patent Rights, in each case whether now or hereafter existing or arising or in which such Grantor now has or hereafter owns, acquires, or develops an interest and wherever located (collectively, the "Patent Collateral"); *provided, however,* that the Liens granted under this Section 2.2 shall be subject and subordinate to the Liens granted to secure the First Lien Obligations under the preceding Section 2.1 and further subject to the subordination provisions of the Intercreditor Agreement. Notwithstanding the foregoing provisions of this Section 2.2, the Patent Collateral shall not include, and no Grantor shall hereby be deemed to grant a security interest in, (1) any rights of such Grantor under any license, lease, agreement, or contract existing as of the Effective Date that expressly prohibits any such security interest (other than in respect of the right to receive money due or to become due under such excluded license, lease, agreement, or contract) or (2) any equipment, inventory, accounts, or fixtures that are subject to any Lien permitted under Section ___ of the Credit Agreement to the extent, but only to the extent, that the documents creating any such Lien expressly prohibit the grant of any such security interest; *provided*, *however*, that in the event that any such prohibition may be waived or avoided on any Grantor's obtaining a consent to such security interest or through the satisfaction of any other condition precedent and such consent is obtained or such condition precedent is satisfied, the foregoing provisions of this sentence shall not be effective with respect to such license, lease, agreement, contract, or Lien.

2.3. Assignment of Patents. In addition, each Grantor acknowledges that the Administrative Agent has the right, in accordance with the power of attorney granted the Administrative Agent hereunder and under the Guarantee and Collateral Agreement, on the occurrence and during the continuance of an Event of Default, to execute on behalf of such Grantor an assignment of Patent Applications and Issued Patents that constitute Patent Collateral in substantially the form of Exhibit 1 hereto (each an "Assignment of Patents") for the sole purpose of effecting the Administrative Agent's exercise of its remedies under Section 7 of this Agreement and Section ___ of the Guarantee and Collateral Agreement. In furtherance of the foregoing, each Grantor hereby authorizes the Administrative Agent to complete, execute, and record with the PTO an Assignment of Patents on behalf of such Grantor on the occurrence and during the continuance of an Event of Default for the sole purpose of effecting the Administrative Agent's exercise of its remedies under Section 7 of this Agreement and Section ___ of the Guarantee and Collateral Agreement.

2.4. Conditional Assignment. In addition to, and not by way of limitation of, the grant and pledge of the Patent Collateral provided in Sections 2.1 and 2.2, each Grantor grants, assigns, transfers, conveys, and sets over to the Administrative Agent, for the benefit of the applicable Secured Parties, such Grantor's entire right, title, and interest in and to the Patent Collateral; *provided*, *however,* that such grant, assignment, transfer, and conveyance shall be and become of force and effect only (a) in connection with the Administrative Agent's exercise of its rights and remedies in strict accordance with the terms of the Credit Agreement and the Guarantee and Collateral Agreement, (b) on or after the occurrence and during the continuance of an Event of Default, and (c) either (i) on written demand of the Administrative Agent at any time during such continuance or (ii) immediately and automatically (without notice or action of any kind by the Administrative Agent) on an Event of Default for which acceleration of the Loans is automatic under the Credit Agreement or on the sale or other disposition of or foreclosure on the Collateral in accordance with the Guarantee and Collateral Agreement and applicable law (including the transfer or other disposition of the Collateral by any Grantor to the Administrative Agent or its nominee in lieu of foreclosure).

2.5. Supplemental to Guarantee and Collateral Agreement. Under the Guarantee and Collateral Agreement, the Grantors have granted to the Administrative Agent, for the benefit of the Secured Creditors, a continuing security interest in and lien on the Collateral (including the Patent Collateral). The Guarantee and Collateral Agreement, and all rights and interests of the Administrative Agent in and to the Collateral (including the Patent Collateral) thereunder, are hereby ratified and confirmed in all respects. In no event shall this Agreement, the grant, assignment, transfer, and conveyance of the Patent Collateral hereunder, or the recordation of this Agreement (or any other document hereunder) with the PTO, adversely affect or impair, in any way or to any extent, the Guarantee and Collateral Agreement, the security interest of the Administrative Agent in the Collateral (including the Patent Collateral) under the Guarantee and Collateral Agreement, the attachment and perfection of such security interest under the UCC (including the security interest in the Patent Collateral), or any present or future rights and interests of the Administrative Agent in and to the Collateral under or in connection with the Guarantee and Collateral Agreement or the UCC. Any and all rights and interests of the Administrative Agent in and to the Patent Collateral (and any and all obligations of the Grantors with respect to the Patent Collateral) provided in, or arising under or in connection with, this

Agreement, shall only supplement and be cumulative and in addition to the rights and interests of the Administrative Agent (and the obligations of the Grantors) in, to, or with respect to the Collateral (including the Patent Collateral) provided in or arising under or in connection with the Guarantee and Collateral Agreement and shall not be in derogation thereof.

3. REPRESENTATIONS, WARRANTIES, AND COVENANTS

Each Grantor represents, warrants, and covenants that: (a) Schedule A sets forth a true and complete list of all Issued Patents and Patent Applications now owned by such Grantor, and constitutes a nonexclusive listing of the Patent Collateral; (b) the Issued Patents and Patent Applications are subsisting and have not been adjudged invalid or unenforceable, in whole or in part, and there is no litigation or proceeding pending or, to the best knowledge of such Grantor, threatened, concerning the validity or enforceability of such Issued Patents and Patent Applications that could reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect; (c) to the best of such Grantor's knowledge, each of the Issued Patents and Patent Applications is valid and enforceable; (d) to the best of such Grantor's knowledge, there is no infringement by others of such Issued Patents, Patent Applications, or Patent Rights; (e) no written or, to the best of such Grantor's knowledge, oral, claim has been made that the use of any of such Patents does or may violate the rights of any third Person, and to the best of such Grantor's knowledge, there is no infringement by such Grantor of the Patent Rights of others; (f) such Grantor is the sole and exclusive owner of the entire and unencumbered right, title, and interest in and to each of such Issued Patents and Patent Applications (other than Liens permitted under Section ____ of the Credit Agreement and other licenses of the Issued Patents in the ordinary course of business), free and clear of any liens, charges, encumbrances, and adverse claims, including pledges, assignments, licenses, registered user agreements, and covenants by such Grantor not to sue third Persons, other than the security interest and assignment created by the Guarantee and Collateral Agreement and this Agreement; (g) such Grantor has the unqualified right to enter into this Agreement and to perform its terms; and (h) such Grantor has used, and will continue to use, proper statutory and other appropriate proprietary notices in connection with its use of the Issued Patents and Patent Applications.

4. NO TRANSFER OR INCONSISTENT AGREEMENTS

Except (a) with the Administrative Agent's prior written consent, (b) for licenses of the Patent Collateral in the ordinary course of the Grantors' business consistent with past practices, or (c) as permitted under the Guarantee and Collateral Agreement, no Grantor will (i) mortgage, pledge, assign, encumber, grant a security interest in, transfer, license, or alienate any of the Patent Collateral, or (ii) enter into any agreement (for example, a license agreement) that is inconsistent with the Grantors' obligations under this Agreement or the Guarantee and Collateral Agreement.

5. AFTER-ACQUIRED PATENTS, ETC.

5.1. After-Acquired Patents. If, prior to the termination of this Agreement in accordance with Section 10, any Grantor shall obtain any right, title, or interest in or to any new patentable inventions or become entitled to the benefit of any Patent Application or Issued Patent for any reissue, division, or continuation of any Issued Patent, the provisions of this Agreement shall automatically apply thereto and such Grantor shall promptly provide to the Administrative Agent notice thereof in writing and execute and deliver to the Administrative Agent such documents or instruments as the Administrative Agent may reasonably request further to implement, preserve, or evidence the Administrative Agent's interest therein.

5.2. Amendment to Schedule. Each Grantor authorizes the Administrative Agent to modify this Agreement and the Assignments of Patents, without the necessity of such Grantor's further approval or signature, by amending Schedule A hereto and the Annex to each Assignment of Patents to include any future or other Patent Rights that become part of the Patent Collateral under Section 2 or Section 5.1.

6. PATENT PROSECUTION

6.1. Grantors Responsible. Each Grantor shall assume full and complete responsibility for the prosecution, defense, enforcement, or any other necessary or desirable actions in connection with the Patent Collateral, and shall hold each of the Secured Creditors harmless from any and all costs, damages, liabilities, and expenses that may be incurred by the Administrative Agent or any other Secured Creditor in connection with the Administrative Agent's interest in the Patent Collateral or any other action or failure to act in connection with this Agreement or the transactions contemplated hereby. In respect of such responsibility, the Grantors shall

retain patent counsel reasonably acceptable to the Administrative Agent.

6.2. Grantors' Duties. Each Grantor shall have the right and the duty, through patent counsel reasonably acceptable to the Administrative Agent, to prosecute reasonably diligently any patent applications of the Patents pending as of the date of this Agreement or thereafter, to preserve and maintain all rights in the Patents, Issued Patents, and Patent Applications (other than with respect to Issued Patents or Patent Applications that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost of maintaining such registrations or applications), including the filing of appropriate renewal applications and other instruments to maintain in effect the Issued Patents and the payment when due of all maintenance fees and other fees, taxes, and other expenses that shall be incurred or that shall accrue with respect to any of the Issued Patents or Patent Applications. Any expenses incurred in connection with such applications and actions shall be borne by the Grantors. Except as otherwise permitted by Section 6.4, no Grantor shall abandon any Patent Application without the consent of the Administrative Agent, which consent shall not be unreasonably withheld (other than with respect to Patent Applications that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost of maintaining such registrations or applications).

6.3. Grantors' Enforcement Rights. Each Grantor shall have the right and the duty to bring suit or other action in such Grantor's own name to maintain and enforce the Patent Rights (other than with respect to Patent Rights that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost thereof). Each Grantor may require the Administrative Agent to join in such suit or action as necessary to assure such Grantor's ability to bring and maintain any such suit or action in any proper forum if (but only if) the Administrative Agent is completely satisfied that such joinder will not subject the Administrative Agent or any other Secured Creditor to any risk of liability. Each Grantor shall promptly, on demand, reimburse and indemnify the Administrative Agent for all damages, costs, and expenses, including reasonable legal fees, incurred by the Administrative Agent pursuant to this Section 6.3.

6.4. Protection of Patents, etc. In general, each Grantor shall take any and all such actions (including institution and maintenance of suits, proceedings, or actions) as may be reasonably necessary or appropriate to properly maintain, protect, preserve, care for, and enforce the Patent Collateral (other than with respect to any Patent Collateral that is no longer used or useful in the business of such Grantor or whose minimal value does not justify the cost of maintaining such Patent Collateral). No Grantor shall take or fail to take any action, nor permit any action to be taken or not taken by others under its control, that would adversely affect the validity, grant, or enforcement of the Patent Collateral.

6.5. Notification by Grantor. Promptly on obtaining knowledge thereof, the Grantors shall notify the Administrative Agent in writing of the institution of, or any final adverse determination in, any proceeding in the PTO or any similar office or agency of the United States or any foreign country, or any court, regarding the validity of any of the Patents or Patent Applications or any Grantor's rights, title, or interests in and to the Patent Collateral, and of any event that does or reasonably could materially adversely affect the value of any of the Patent Collateral, the ability of any Grantor or the Administrative Agent to dispose of any of the Patent Collateral, or the rights and remedies of the Administrative Agent in relation thereto (including but not limited to the levy of any legal process against any of the Patent Collateral).

7. REMEDIES

In addition to all other rights and remedies set forth elsewhere in this Agreement, on the occurrence and during the continuance of an Event of Default, the Administrative Agent shall have all of the rights and remedies set forth in the Guarantee and Collateral Agreement and the Credit Agreement.

8. ADMINISTRATIVE AGENT MAY PERFORM

If any Grantor fails to perform any of its obligations in this Agreement, the Administrative Agent may itself perform, or cause performance of, such obligation, and the expenses of the Administrative Agent incurred in connection therewith shall be payable by Grantors under Section 11.

9. FURTHER ASSURANCES

Each Grantor shall, at any time and from time to time, and at its expense, make, execute, acknowledge, and deliver, and file and record as necessary or appropriate with Governmental Authorities, such agreements,

assignments, documents, and instruments, and do such other and further acts and things (including, without limitation, obtaining consents of third parties), as the Administrative Agent may request or as may be reasonably necessary or appropriate in order to implement and effect fully the intentions, purposes, and provisions of this Agreement, or to assure and confirm to the Administrative Agent the grant, perfection, and priority of the Administrative Agent's security interest in the Patent Collateral.

10. TERMINATION

On the indefeasible payment in full in cash of the Obligations (other than Obligations that are contingent and unliquidated and not due and owing on such date and that, under the provisions of the Credit Agreement or the other Loan Documents, survive the termination of the Credit Agreement or the repayment of the Obligations) and the cancellation, expiration, or termination of the Commitment, this Agreement shall terminate and the Administrative Agent shall, on the written request and at the expense of the respective Grantors, execute and deliver to such Grantors all deeds, assignments, and other instruments as may be necessary or proper to reassign and reconvey to and re-vest in the Grantors the entire right, title, and interest to the Patent Collateral previously granted, assigned, transferred, and conveyed to the Administrative Agent by the Grantors under this Agreement, as fully as if this Agreement had not been made, subject to any disposition of all or any part thereof that may have been made by the Administrative Agent in accordance with this Agreement or the Guarantee and Collateral Agreement.

11. EXPENSES

Any and all fees, costs, and expenses, of whatever kind or nature, including reasonable attorney fees and expenses incurred by the Administrative Agent in connection with the preparation of this Agreement and all other documents relating hereto, the consummation of the transactions contemplated hereby or the enforcement hereof, the filing or recording of any documents (including all taxes in connection therewith) in public offices, the payment or discharge of any taxes, counsel fees, maintenance or renewal fees, or encumbrances, or otherwise protecting, maintaining, or preserving the Patent Collateral, or in defending or prosecuting any actions or proceedings arising out of or related to the Patent Collateral, shall be borne and paid by the Grantors.

12. OVERDUE AMOUNTS

Until paid, all amounts due and payable by the Grantors hereunder shall be a debt secured by the Patent Collateral and other Collateral and shall bear, whether before or after judgment, interest at the rate of interest after an Event of Default set forth in the Credit Agreement.

13. NO ASSUMPTION OF LIABILITY; INDEMNIFICATION

NOTWITHSTANDING ANYTHING TO THE CONTRARY IN THIS AGREEMENT, NEITHER THE ADMINISTRATIVE AGENT NOR ANY OTHER SECURED PARTY ASSUMES ANY LIABILITIES OF ANY GRANTOR WITH RESPECT TO ANY CLAIM OR CLAIMS REGARDING SUCH GRANTOR'S OWNERSHIP OR PURPORTED OWNERSHIP OF, OR RIGHTS OR PURPORTED RIGHTS ARISING FROM, ANY OF THE PATENT COLLATERAL OR ANY USE, LICENSE, OR SUBLICENSE THEREOF, WHETHER ARISING OUT OF ANY PAST, CURRENT, OR FUTURE EVENT, CIRCUMSTANCE, ACT, OR OMISSION, OR OTHERWISE. ALL OF SUCH LIABILITIES SHALL BE EXCLUSIVELY THE RESPONSIBILITY OF SUCH GRANTOR, AND SUCH GRANTOR SHALL INDEMNIFY THE ADMINISTRATIVE AGENT AND THE OTHER SECURED PARTIES FOR ANY AND ALL COSTS, EXPENSES, DAMAGES, AND CLAIMS, INCLUDING LEGAL FEES, INCURRED BY THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED CREDITOR WITH RESPECT TO SUCH LIABILITIES; *PROVIDED*, *HOWEVER,* THAT NOTHING HEREIN SHALL LIMIT ANY DUTY THAT THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED CREDITOR MAY HAVE UNDER APPLICABLE LAW TO ACT IN A COMMERCIALLY REASONABLE MANNER.

14. NOTICES

All notices and other communications under or related to this Agreement shall be made in writing and, unless otherwise specifically provided herein, shall be deemed to have been duly made or given when delivered by hand or mailed first class, postage prepaid, or, in the case of telegraphic or telexed notice, when transmitted, answer back received, addressed as follows: if to the Grantors, at the address set forth beneath their signatures hereto, and if to the Administrative Agent, at the address for notices to the Administrative Agent set forth in Section ____ of the Credit Agreement, or at such address as either party may designate in

writing to the other.

15. AMENDMENT AND WAIVER

This Agreement is subject to modification only by a writing signed by the Administrative Agent and the Grantors, and otherwise in accordance with Section ____ of the Credit Agreement, except as provided in Section 5.2. The Administrative Agent shall not be deemed to have waived any right hereunder unless such waiver shall be in writing and signed by the Administrative Agent and otherwise in accordance with Section ____ of the Credit Agreement. A waiver on any one occasion shall not be construed as a bar to or waiver of any right on any future occasion.

16. GOVERNING LAW; CONSENT TO JURISDICTION

THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAW OF THE STATE OF NEW YORK, WITHOUT REGARD TO ITS CONFLICT OF LAW PROVISIONS.

17. WAIVER OF JURY TRIAL

EACH GRANTOR AND, BY ACCEPTANCE OF THE BENEFITS HEREOF, EACH SECURED PARTY HEREBY IRREVOCABLY AND UNCONDITIONALLY WAIVES TRIAL BY JURY IN ANY LEGAL ACTION OR PROCEEDING RELATING TO THIS AGREEMENT OR ANY OTHER LOAN DOCUMENT AND FOR ANY COUNTERCLAIM THEREIN.

18. MISCELLANEOUS

The headings of each section of this Agreement are for convenience only and shall not define or limit the provisions thereof. This Agreement and all rights and obligations hereunder shall be binding on each Grantor and its respective successors and assigns, and shall inure to the benefit of the Administrative Agent, the other Secured Creditors, and their respective successors and assigns. If any term of this Agreement is held to be invalid, illegal, or unenforceable, the validity of all other terms hereof shall in no way be affected thereby, and this Agreement shall be construed and be enforceable as if such invalid, illegal, or unenforceable term had not been included herein. Each Grantor acknowledges receipt of a copy of this Agreement.

19. ADMINISTRATIVE AGENT AS AGENT

19.1. The Administrative Agent has been appointed to act as Administrative Agent hereunder by the Lenders. The Administrative Agent shall be obligated, and shall have the right hereunder, to make demands, to give notices, to exercise or refrain from exercising any rights, and to take or refrain from taking any action (including, without limitation, the release or substitution of Collateral), solely in accordance with this Agreement, the Guarantee and Collateral Agreement, and the Credit Agreement, and on the instructions of the Required Lenders, hereby agrees to be bound by such instructions.

19.2. The Administrative Agent shall at all times be the same Person that is the Administrative Agent under the Credit Agreement.

IN WITNESS WHEREOF, this Patent Collateral Security and Pledge Agreement has been executed as of the day and year first above written.

Borrower 1

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Borrower 2

_ _[*NAME OF CORPORATION*]_ _,

a _ _[*state of incorporation*]_ _ corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Sole Lead Arranger and Sole Book Manager

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Administrative Agent

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ corporation

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgements*]

SCHEDULE A
TO
PATENT COLLATERAL SECURITY AND PLEDGE AGREEMENT

[*To be completed by the Borrower*]

Grantor: _ _[*name*]_ _

Issued U.S. Patents of Grantor

Patent No.	Issue Date	Title

SCHEDULE B

TO
PATENT COLLATERAL SECURITY AND PLEDGE AGREEMENT

[*To be completed by the Borrower*]

Pending U.S. Patent Applications of Grantor

Serial No.	Filing Date	Title

EXHIBIT 1
TO
PATENT COLLATERAL SECURITY AND PLEDGE AGREEMENT

ASSIGNMENT OF PATENTS

WHEREAS, _ _[*name*]_ _, a _ _[*e.g., corporation*]_ _ organized and existing under the laws of the State of _ _[*e.g., California*]_ _, having a place of business at _ _[*address*]_ _ (the "Assignor"), has adopted and used and is using the patents (the "Patents") identified on the Annex hereto, and is the owner of such Patents; and

WHEREAS, _ _[*name*]_ _, a _ _[*e.g., corporation*]_ _, having a place of business at _ _[*address*]_ _ (the "Assignee"), is desirous of acquiring the Patents;

WHEREAS, the Assignor and the Assignee have entered into that certain Patent Collateral Security and Pledge Agreement, dated as of _ _[*date*]_ _ (as it may be amended, "Patent Collateral Agreement"). Capitalized terms used and not defined herein have the meanings given such terms in the Patent Collateral Agreement;

NOW, THEREFORE, for good and valuable consideration, receipt of which is hereby acknowledged, the Assignor does hereby assign, sell, and transfer to the Assignee all right, title, and interest in and to the Patents, together with (i) the Issued Patents and Patent Applications identified on the Annex attached hereto and incorporated herein by reference, (ii) the goodwill of the business symbolized by and associated with the Patents, and (iii) the right to sue and recover for, and the right to profits or damages due or accrued arising out of or in connection with, any and all past, present, or future infringements of or damage or injury to the Patents or such associated goodwill.

This Assignment of Patents is intended to and shall take effect at such time as the Assignee shall complete this instrument by signing its acceptance of this Assignment of Patents below.

IN WITNESS WHEREOF, the Assignor, by its duly authorized officer, has executed this assignment, on

_ _[*date*]_ _.

Assignor:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

The foregoing assignment of the Patents by the Assignor to the Assignee is hereby accepted as of _ _[*date*]_ _.

Assignee:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

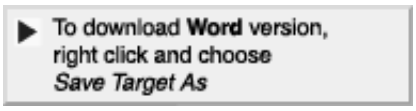
[*Add applicable notarial acknowledgement*]

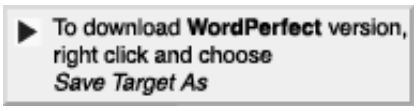
[*Add Annex describing patents and applications*]

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Appendix D-2

Trademark Collateral Security and Pledge Agreement





TRADEMARK COLLATERAL SECURITY AND PLEDGE AGREEMENT

This TRADEMARK COLLATERAL SECURITY AND PLEDGE AGREEMENT, dated as of _ _[*date*]_ _ (as it may be amended, restated, supplemented, or otherwise modified from time to time, this "Agreement"), is made by each of the signatories hereto (collectively, the "Grantors") in favor of _ _[*name*]_ _, as administrative agent (in such capacity, the "Administrative Agent") for the Borrowers (as defined in the Credit Agreement referred to below).

RECITALS

A. _ _[*Name*]_ _, a _ _[*e.g., California corporation*]_ _ ("Borrower 1"), and _ _[*name*]_ _, a _ _[*e.g., California corporation*]_ _ ("Borrower 2" and, together with Borrower 1, the "Borrowers"), have entered into a Credit Agreement, dated as of _ _[*date*]_ _ (as amended, supplemented, or otherwise modified from time to time, the "Credit Agreement"), with the banks and other financial institutions and entities from time to time party thereto (the "Lenders"), and _ _[*name*]_ _, as sole lead arranger and sole bookrunner, and the Administrative Agent. Capitalized terms used and not defined herein have the meanings given such terms in the Credit Agreement.

B. It is a condition precedent to the obligation of the Lenders to make their respective extensions of credit to the Borrowers under the Credit Agreement that the Grantors shall have executed and delivered that certain Guarantee and Collateral Agreement, dated as of _ _[*date*]_ _, in favor of the Administrative Agent (as amended, supplemented, replaced, or otherwise modified from time to time, the "Guarantee and Collateral Agreement").

C. Under the terms of the Guarantee and Collateral Agreement, the Grantors have granted a security interest in certain Property, including, without limitation, certain Intellectual Property, of the Grantors to the Administrative Agent for the ratable benefit of the Secured Parties, and have agreed as a condition thereof to execute this Agreement for recording with the United States Patent and Trademark Office and other applicable Governmental Authorities.

D. This Agreement is supplemental to the provisions contained in the Guarantee and Collateral Agreement and the Credit Agreement and, in the event of an inconsistency among them, the Credit Agreement shall control over the Guarantee and Collateral Agreement and the Guarantee and Collateral Agreement shall control over this Agreement.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Grantors agree as follows:

1. DEFINITIONS

1.1. Terms Defined in the Credit Agreement and the Guarantee and Collateral Agreement. All capitalized terms used in this Agreement and not otherwise defined herein shall have the meanings assigned to them in the Credit Agreement and the Guarantee and Collateral Agreement.

1.2. Certain Defined Terms. As used in this Agreement, the following terms shall have the following meanings:

"Assignment of Marks" has the meaning set forth in Section 2.1 herein.

"Associated Goodwill" means all goodwill of each Grantor and its business, products, and services appurtenant to, associated with, or symbolized by the Trademarks and the use thereof.

"Common Law Rights" means all right, title, and interest in and to any Trademarks currently used, intended to be used, or used in the past for which Trademark Applications have not been filed or Trademark Registrations have not issued.

"PTO" means the United States Patent and Trademark Office.

"Related Assets" means all assets, rights, and interests of each Grantor that uniquely reflect or embody the Associated Goodwill.

"Trademark Applications" means all past, present, or future applications for any trademark in the name of any Grantor.

"Trademark Collateral" has the meaning set forth in Section 2.1.

"Trademark Registrations" means all past, present, or future federal, state, local, and foreign registrations of the Trademarks, including, but not limited to, those set forth on Schedule A, together with the right (but not the obligation) to apply for such registrations (and prosecute such applications) in the name of any Grantor or the Administrative Agent, and to take any and all actions necessary or appropriate to maintain such registrations in effect and renew and extend such registrations.

"Trademark Rights" means any and all past, present, or future rights in, to, and associated with the Trademarks throughout the world, whether arising under federal law, state law, common law, foreign law, or otherwise, including the following: all such rights arising out of or associated with the Trademark Registrations, Trademark Applications, or Common Law Trademarks; the right (but not the obligation) to register claims under any state, federal, or foreign trademark law or regulation; the right (but not the obligation) to sue or bring opposition or cancellation proceedings in the name of any Grantor or the Administrative Agent for any and all past, present, and future infringements or dilution of or any other damages or injury to the Trademarks, the Trademark Rights, or the Associated Goodwill, and the rights to damages or profits due or accrued arising out of or in connection with any such past, present, or future infringement, dilution, damage, or injury.

"Trademarks" means all of the trademarks, service marks, designs, logos, indicia, trade names, corporate names, company names, business names, fictitious business names, trade styles, elements of package or trade dress, and other source and product or service identifiers, used or associated with or appurtenant to the products, services, and businesses of each Grantor in which such Grantor now has or in the future acquires any right, title, or interest.

1.3. Rules of Interpretation. Unless otherwise provided herein, the rules of interpretation set forth in Section ____ of the Credit Agreement shall be applicable to this Agreement.

2. GRANT OF SECURITY INTEREST

2.1. Security Interest; Assignment of Trademarks. As collateral security for the payment and performance in full of all of the Obligations, each Grantor hereby grants to the Administrative Agent, for the benefit of the Administrative Agent and the ratable benefit of the Secured Parties, a continuing security interest in and first priority lien on all of such Grantor's rights, title, and interests in all Trademarks, Trademark Applications, Trademark Registrations, Common Law Trademarks, and Trademark Rights, in each case whether now or hereafter existing or arising or in which such Grantor now has or hereafter owns, acquires, or develops an interest and wherever located (collectively, the "Trademark Collateral"). Notwithstanding the foregoing provisions of this Section 2.1, the Trademark Collateral shall not include, and no Grantor shall hereby be deemed to grant a security interest in, (i) any rights of such Grantor under any license, lease, agreement, or contract existing as of the Effective Date that expressly prohibits any such security interest (other than in respect of the right to receive money due or to become due under such excluded license, lease, agreement, or contract) or (ii) any equipment, inventory, accounts, or fixtures that are subject to any Lien permitted under Section ____ of the Credit Agreement to the extent, but only to the extent, that the documents creating any

such Lien expressly prohibit the grant of any such security interest; *provided*, *however*, that in the event that any such prohibition may be waived or avoided on any Grantor's obtaining a consent to such security interest or through the satisfaction of any other condition precedent and such consent is obtained or such condition precedent is satisfied, the foregoing provisions of this sentence shall not be effective with respect to such license, lease, agreement, contract, or Lien. In addition, each Grantor acknowledges that the Administrative Agent has the right, pursuant to the power of attorney granted the Administrative Agent hereunder and under the Guarantee and Collateral Agreement, on the occurrence and during the continuance of an Event of Default, to execute on behalf of such Grantor an assignment of Trademark Applications and Trademark Registrations that constitute Trademark Collateral in substantially the form of Exhibit 1 hereto (each an "Assignment of Trademarks") for the sole purpose of effecting the Administrative Agent's exercise of its remedies under Section 7 of this Agreement and Section 6 of the Guarantee and Collateral Agreement. In furtherance of the foregoing, each Grantor hereby authorizes the Administrative Agent to complete, execute, and record with the PTO an Assignment of Trademarks on behalf of such Grantor on the occurrence and during the continuance of an Event of Default for the sole purpose of effecting the Administrative Agent's exercise of its remedies under Section 7 of this Agreement and Section 6 of the Guarantee and Collateral Agreement.

2.2. Conditional Assignment. In addition to, and not by way of limitation of, the grant and pledge of the Trademark Collateral provided in Section 2.1, each Grantor grants, assigns, transfers, conveys, and sets over to the Administrative Agent, for the benefit of the Secured Parties, such Grantor's entire right, title, and interest in and to the Trademark Collateral; *provided, however*, that such grant, assignment, transfer, and conveyance shall be and become of force and effect only (a) in connection with the Administrative Agent's exercise of its rights and remedies in strict accordance with the terms of the Credit Agreement and the Guarantee and Collateral Agreement, and (b) on or after the occurrence and during the continuance of an Event of Default and (c) either (i) on the written demand of the Administrative Agent at any time during such continuance or (ii) immediately and automatically (without notice or action of any kind by the Administrative Agent) on an Event of Default for which acceleration of the Loans is automatic under the Credit Agreement or on the sale or other disposition of or foreclosure on the Collateral under the Guarantee and Collateral Agreement and applicable law (including the transfer or other disposition of the Collateral by any Grantor to the Administrative Agent or its nominee in lieu of foreclosure).

2.3. Supplemental to Guarantee and Collateral Agreement. Under the Guarantee and Collateral Agreement, the Grantors have granted to the Administrative Agent, for the benefit of the Secured Creditors, a continuing security interest in and lien on the Collateral (including the Trademark Collateral). The Guarantee and Collateral Agreement, and all rights and interests of the Administrative Agent in and to the Collateral (including the Trademark Collateral) thereunder, are hereby ratified and confirmed in all respects. In no event shall this Agreement, the grant, assignment, transfer, and conveyance of the Trademark Collateral hereunder, or the recordation of this Agreement (or any other document hereunder) with the PTO, adversely affect or impair, in any way or to any extent, the Guarantee and Collateral Agreement, the security interest of the Administrative Agent in the Collateral (including the Trademark Collateral) under the Guarantee and Collateral Agreement, the attachment and perfection of such security interest under the UCC (including the security interest in the Trademark Collateral), or any present or future rights and interests of the Administrative Agent in and to the Collateral under or in connection with the Guarantee and Collateral Agreement or the UCC. Any and all rights and interests of the Administrative Agent in and to the Trademark Collateral (and any and all obligations of the Grantors with respect to the Trademark Collateral) provided in, or arising under or in connection with, this Agreement shall only supplement and be cumulative and in addition to the rights and interests of the Administrative Agent (and the obligations of the Grantors) in, to, or with respect to the Collateral (including the Trademark Collateral) provided in or arising under or in connection with the Guarantee and Collateral Agreement and shall not be in derogation thereof.

3. REPRESENTATIONS, WARRANTIES, AND COVENANTS

Each Grantor represents, warrants, and covenants that: (a) Schedule A sets forth a true and complete list of all Trademark Registrations and Trademark Applications now owned by such Grantor, and constitutes a nonexclusive listing of the Trademark Collateral; (b) the Trademark Registrations and Trademark Applications are subsisting and have not been adjudged invalid or unenforceable, in whole or in part, and there is no litigation or proceeding pending or, to the best knowledge of such Grantor, threatened, concerning the validity or enforceability of such Trademark Registrations and Trademark Applications that could reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect; (c) to the best of such Grantor's knowledge, each of the Trademark Registrations and Trademark Applications is valid and enforceable; (d) to the best of such Grantor's knowledge, there is no infringement by others of such Trademark

Registrations, Trademark Applications, or Trademark Rights; (e) no written or, to the best of such Grantor's knowledge, oral, claim has been made that the use of any of such Trademarks does or may violate the rights of any third Person, and to the best of such Grantor's knowledge, there is no infringement by such Grantor of the Trademark Rights of others; (f) such Grantor is the sole and exclusive owner of the entire and unencumbered right, title, and interest in and to each of such Trademark Registrations and Trademark Applications (other than Liens permitted under Section ____ of the Credit Agreement and other licenses of the Trademarks in the ordinary course of business), free and clear of any liens, charges, encumbrances, and adverse claims, including pledges, assignments, licenses, registered user agreements, and covenants by such Grantor not to sue third Persons, other than the security interest and assignment created by the Guarantee and Collateral Agreement and this Agreement; (g) such Grantor has the unqualified right to enter into this Agreement and to perform its terms; and (h) such Grantor has used, and will continue to use, proper statutory and other appropriate proprietary notices in connection with its use of the Trademark Registrations, Trademark Applications, and Common Law Trademarks.

4. NO TRANSFER OR INCONSISTENT AGREEMENTS

Except (a) with the Administrative Agent's prior written consent, (b) for licenses of the Trademark Collateral in the ordinary course of the Grantors' business consistent with past practices, or (c) as permitted under the Guarantee and Collateral Agreement, no Grantor will (i) mortgage, pledge, assign, encumber, grant a security interest in, transfer, license, or alienate any of the Trademark Collateral, or (ii) enter into any agreement (for example, a license agreement) that is inconsistent with the Grantors' obligations under this Agreement or the Guarantee and Collateral Agreement.

5. AFTER-ACQUIRED TRADEMARKS, ETC.

5.1. After-Acquired Trademarks. If, prior to the termination of this Agreement in accordance with Section 10, any Grantor obtains any right, title, or interest in or to any other or new Trademarks, Trademark Registrations, Trademark Applications, Common Law Trademarks, or Trademark Rights, or becomes entitled to the benefit of any Trademarks, Trademark Registrations, Trademark Applications, Common Law Trademarks, or Trademark Rights, the provisions of this Agreement shall automatically apply thereto and such Grantor shall promptly provide to the Administrative Agent notice thereof in writing and execute and deliver to the Administrative Agent such documents or instruments as the Administrative Agent may reasonably request further to implement, preserve, or evidence the Administrative Agent's interest therein.

5.2. Amendment to Schedule. Each Grantor authorizes the Administrative Agent to modify this Agreement and the Assignments of Trademarks, without the necessity of such Grantor's further approval or signature, by amending Schedule A hereto and the Annex to each Assignment of Trademarks to include any future or other Trademark Rights that become part of the Trademark Collateral under Section 2 or Section 5.1.

6. TRADEMARK PROSECUTION

6.1. Grantors Responsible. Each Grantor shall assume full and complete responsibility for the prosecution, defense, enforcement, or any other necessary or desirable actions in connection with the Trademark Collateral, and shall hold each of the Secured Creditors harmless from any and all costs, damages, liabilities, and expenses that may be incurred by the Administrative Agent or any other Secured Creditor in connection with the Administrative Agent's interest in the Trademark Collateral or any other action or failure to act in connection with this Agreement or the transactions contemplated hereby. In respect of such responsibility, the Grantors shall retain trademark counsel reasonably acceptable to the Administrative Agent.

6.2. Grantors' Duties, etc. Each Grantor shall have the right and the duty, through trademark counsel reasonably acceptable to the Administrative Agent, to prosecute reasonably diligently any Trademark Applications of the Trademarks pending as of the date of this Agreement or thereafter, to preserve and maintain all rights in the Trademarks, Trademark Registrations, and Trademark Applications (other than with respect to Trademark Registrations or Trademark Applications that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost of maintaining such registrations or applications), including the filing of appropriate renewal applications and other instruments to maintain in effect the Trademark Registrations and the payment when due of all registration renewal fees and other fees, taxes, and other expenses that are incurred or that shall accrue with respect to any of the Trademark Registrations or Trademark Applications. Any expenses incurred in connection with such applications and actions shall be borne by the Grantors. Except as otherwise permitted by Section 6.4, no

Grantor shall abandon any Trademark Application without the consent of the Administrative Agent (other than with respect to Trademark Applications that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost of maintaining such registrations or applications), which consent shall not be unreasonably withheld

6.3. Grantors' Enforcement Rights. Each Grantor shall have the right and the duty to bring suit or other action in such Grantor's own name to maintain and enforce the Trademark Rights (other than with respect to Trademark Rights that are no longer used or useful in the business of such Grantor or whose minimal value does not reasonably justify the cost thereof). Each Grantor may require the Administrative Agent to join in such suit or action as necessary to assure such Grantor's ability to bring and maintain any such suit or action in any proper forum if (but only if) the Administrative Agent is completely satisfied that such joinder will not subject the Administrative Agent or any other Secured Creditor to any risk of liability. Each Grantor shall promptly, on demand, reimburse and indemnify the Administrative Agent for all damages, costs, and expenses, including reasonable legal fees, incurred by the Administrative Agent under this Section 6.3.

6.4. Protection of Trademarks, etc. In general, each Grantor shall take any and all such actions (including institution and maintenance of suits, proceedings, or actions) as may be reasonably necessary or appropriate to properly maintain, protect, preserve, care for, and enforce the Trademark Collateral (other than with respect to Trademark Collateral that are no longer used or useful in the business of such Grantor or whose minimal value does not justify the cost of maintaining such Trademark Collateral). No Grantor shall take or fail to take any action, nor permit any action to be taken or not taken by others under its control, that would adversely affect the validity, grant, or enforcement of the Trademark Collateral.

6.5. Notification by Grantor. Promptly on obtaining knowledge thereof, the Grantors shall notify the Administrative Agent in writing of the institution of, or any final adverse determination in, any proceeding in the PTO or any similar office or agency of the United States or any foreign country, or any court, regarding the validity of any of the Trademarks or any Grantor's rights, title, or interests in and to the Trademark Collateral, and of any event that does or reasonably could materially adversely affect the value of any of the Trademark Collateral, the ability of any Grantor or the Administrative Agent to dispose of any of the Trademark Collateral, or the rights and remedies of the Administrative Agent in relation thereto (including but not limited to the levy of any legal process against any of the Trademark Collateral).

7. REMEDIES

In addition to all other rights and remedies set forth elsewhere in this Agreement, on the occurrence and during the continuance of an Event of Default, the Administrative Agent shall have all of the rights and remedies set forth in the Guarantee and Collateral Agreement and the Credit Agreement.

8. ADMINISTRATIVE AGENT MAY PERFORM

If any Grantor fails to perform any agreement contained herein, the Administrative Agent may itself perform, or cause performance of, such agreement, and the expenses of the Administrative Agent incurred in connection therewith shall be payable by Grantors under Section 11.

9. FURTHER ASSURANCES

Each Grantor shall, at any time and from time to time, and at its expense, make, execute, acknowledge, and deliver, and file and record as necessary or appropriate with Governmental Authorities, such agreements, assignments, documents, and instruments, and do such other and further acts and things (including, without limitation, obtaining consents of third parties), as the Administrative Agent may request or as may be reasonably necessary or appropriate in order to implement and effect fully the intentions, purposes, and provisions of this Agreement, or to assure and confirm to the Administrative Agent the grant, perfection, and priority of the Administrative Agent's security interest in the Trademark Collateral.

10. TERMINATION

On the indefeasible payment in full in cash of the Obligations (other than Obligations that are contingent and unliquidated and not due and owing on such date and that under the provisions of the Credit Agreement or the other Loan Documents survive the termination of the Credit Agreement or the repayment of the Obligations) and the cancellation, expiration, or termination of the Commitment, this Agreement shall terminate and the

Administrative Agent shall, on the written request and at the expense of the respective Grantors, execute and deliver to such Grantors all deeds, assignments, and other instruments as may be necessary or proper to reassign and reconvey to and re-vest in the Grantors the entire right, title, and interest to the Trademark Collateral previously granted, assigned, transferred, and conveyed to the Administrative Agent by the Grantors under this Agreement, as fully as if this Agreement had not been made, subject to any disposition of all or any part thereof that may have been made by the Administrative Agent under this Agreement or the Guarantee and Collateral Agreement.

11. EXPENSES

Any and all fees, costs, and expenses, of whatever kind or nature, including reasonable attorney fees and expenses incurred by the Administrative Agent in connection with the preparation of this Agreement and all other documents relating hereto, the consummation of the transactions contemplated hereby or the enforcement hereof, the filing or recording of any documents (including all taxes in connection therewith) in public offices, the payment or discharge of any taxes, counsel fees, maintenance or renewal fees, or encumbrances, or otherwise protecting, maintaining, or preserving the Trademark Collateral, or in defending or prosecuting any actions or proceedings arising out of or related to the Trademark Collateral, shall be borne and paid by the Grantors.

12. OVERDUE AMOUNTS

Until paid, all amounts due and payable by the Grantors hereunder shall be a debt secured by the Trademark Collateral and other Collateral and shall bear, whether before or after judgment, interest at the rate of interest after an Event of Default set forth in the Credit Agreement.

13. NO ASSUMPTION OF LIABILITY; INDEMNIFICATION

NOTWITHSTANDING ANYTHING TO THE CONTRARY IN THIS AGREEMENT, NEITHER THE ADMINISTRATIVE AGENT NOR ANY OTHER SECURED PARTY ASSUMES ANY LIABILITIES OF ANY GRANTOR WITH RESPECT TO ANY CLAIM OR CLAIMS REGARDING SUCH GRANTOR'S OWNERSHIP OR PURPORTED OWNERSHIP OF, OR RIGHTS OR PURPORTED RIGHTS ARISING FROM, ANY OF THE TRADEMARK COLLATERAL OR ANY USE, LICENSE, OR SUBLICENSE THEREOF, WHETHER ARISING OUT OF ANY PAST, CURRENT, OR FUTURE EVENT, CIRCUMSTANCE, ACT, OR OMISSION, OR OTHERWISE. ALL OF SUCH LIABILITIES SHALL BE EXCLUSIVELY THE RESPONSIBILITY OF SUCH GRANTOR, AND SUCH GRANTOR SHALL INDEMNIFY THE ADMINISTRATIVE AGENT AND THE OTHER SECURED PARTIES FOR ANY AND ALL COSTS, EXPENSES, DAMAGES, AND CLAIMS, INCLUDING LEGAL FEES, INCURRED BY THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED CREDITOR WITH RESPECT TO SUCH LIABILITIES; *PROVIDED*, *HOWEVER,* THAT NOTHING HEREIN SHALL LIMIT ANY DUTY THAT THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED CREDITOR MAY HAVE UNDER APPLICABLE LAW TO ACT IN A COMMERCIALLY REASONABLE MANNER.

14. NOTICES

All notices and other communications under or related to this Agreement shall be made in writing and, unless otherwise specifically provided herein, shall be deemed to have been duly made or given when delivered by hand or mailed first class, postage prepaid, or, in the case of telegraphic or telexed notice, when transmitted, answer back received, addressed as follows: if to the Grantors, at the address set forth beneath their signatures hereto, and if to the Administrative Agent, at the address for notices to the Administrative Agent set forth in Section ____ of the Credit Agreement, or at such address as either party may designate in writing to the other.

15. AMENDMENT AND WAIVER

This Agreement is subject to modification only by a writing signed by the Administrative Agent and the Grantors, and otherwise in accordance with Section ____ of the Credit Agreement, except as provided in Section 5.2. The Administrative Agent shall not be deemed to have waived any right hereunder unless such waiver is in writing and signed by the Administrative Agent and is otherwise in accordance with Section ____ of the Credit Agreement. A waiver on any one occasion shall not be construed as a bar to or waiver of any right on any future occasion.

16. GOVERNING LAW; CONSENT TO JURISDICTION

THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAW OF THE STATE OF NEW YORK, WITHOUT REGARD TO ITS CONFLICT OF LAW PROVISIONS.

17. WAIVER OF JURY TRIAL

EACH GRANTOR AND, BY ACCEPTANCE OF THE BENEFITS HEREOF, EACH SECURED PARTY HEREBY IRREVOCABLY AND UNCONDITIONALLY WAIVES TRIAL BY JURY IN ANY LEGAL ACTION OR PROCEEDING RELATING TO THIS AGREEMENT OR ANY OTHER LOAN DOCUMENT AND FOR ANY COUNTERCLAIM THEREIN.

18. MISCELLANEOUS

The headings of each section of this Agreement are for convenience only and shall not define or limit the provisions thereof. This Agreement and all rights and obligations hereunder shall be binding on each Grantor and its respective successors and assigns, and shall inure to the benefit of the Administrative Agent, the other Secured Creditors, and their respective successors and assigns. If any term of this Agreement is held to be invalid, illegal, or unenforceable, the validity of all other terms hereof shall in no way be affected thereby, and this Agreement shall be construed and be enforceable as if such invalid, illegal, or unenforceable term had not been included herein. Each Grantor acknowledges receipt of a copy of this Agreement.

19. ADMINISTRATIVE AGENT AS AGENT

(a) The Administrative Agent has been appointed to act as Administrative Agent hereunder by the Lenders. The Administrative Agent shall be obligated, and shall have the right under this Agreement, to make demands, to give notices, to exercise or refrain from exercising any rights, and to take or refrain from taking any action (including, without limitation, the release or substitution of Collateral), solely in accordance with this Agreement, the Guarantee and Collateral Agreement, and the Credit Agreement, and on the instructions of the Required Lenders, hereby agrees to be bound by such instructions.

(b) The Administrative Agent shall at all times be the same Person that is the Administrative Agent under the Credit Agreement.

IN WITNESS WHEREOF, this Agreement has been executed as of the day and year first above written.

Borrower 1

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Borrower 2

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Sole Lead Arranger and Sole Book Manager

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _

Its: _ _[*Title*]_ _

Administrative Agent

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgements*]

SCHEDULE A
TO
TRADEMARK COLLATERAL SECURITY AND PLEDGE AGREEMENT

[*To be completed by the Borrower*]

Grantor: _ _[*name*]_ _

United States Trademark Registrations of Grantor

Trademark	Registration No.	Registration Date

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Appendix D-3

Copyright and Trade Secret Collateral Security Agreement

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COPYRIGHT AND TRADE SECRET COLLATERAL SECURITY AGREEMENT

This COPYRIGHT AND TRADE SECRET COLLATERAL SECURITY AGREEMENT, dated as of _ _[*date*]_ _ (as amended, supplemented, or otherwise modified from time to time, this "Agreement"), is made by each of the signatories hereto (collectively, the "Grantors") in favor of _ _[*name*]_ _, as administrative agent (in such capacity, the "Administrative Agent") for the First Lien Secured Parties and the Second Lien Secured Parties (each such term as defined in the Credit Agreement referred to below).

RECITALS

A. _ _[*Name*]_ _, a _ _[*e.g., California*]_ _ corporation ("Assignor 1"), and _ _[*name*]_ _, a _ _[*e.g., California*]_ _ corporation ("Assignor 2," and, together with Assignor 1, the "Borrowers"), have entered into a Credit Agreement, dated as of _ _[*date*]_ _ (as amended, supplemented, or otherwise modified from time to time, the "Credit Agreement"), with the banks and other financial institutions and entities from time to time party thereto (the "Lenders"), _ _[*name*]_ _, as sole lead arranger and sole book manager, and _ _[*name*]_ _, as administrative agent (in such capacity, the "Administrative Agent").

B. It is a condition precedent to the obligation of the Lenders to make their respective extensions of credit to the Borrowers under the Credit Agreement that the Borrowers and Grantors shall have executed and delivered that certain Guarantee and Collateral Agreement, dated as of _ _[*date*]_ _, in favor of the Administrative Agent (as amended, supplemented, replaced, or otherwise modified from time to time, the "Guarantee and Collateral Agreement").

C. Under the terms of the Guarantee and Collateral Agreement, the Grantors have granted certain first and second priority security interests in certain Property, including, without limitation, certain Intellectual Property of the Grantors, to the Administrative Agent for the ratable benefit of the First Lien Secured Parties and the Second Lien Secured Parties, respectively, and have agreed as a condition thereof to execute this Agreement for recording with the United States Copyright Office and other applicable Governmental Authorities.

AGREEMENT

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Grantors agree as follows:

1. Grant of Security Interest for First Lien Secured Parties. It being expressly understood and agreed that the security interests granted in this Agreement for the benefit of the First Lien Secured Parties shall be subject to the provisions of the Intercreditor Agreement, each Grantor hereby grants to the Administrative Agent, for the ratable benefit of the First Lien Secured Parties, a continuing security interest in and first priority Lien on all of such Grantor's rights, title, and interests in and to the following, whether now owned or existing or hereafter acquired or arising and wherever located (the "Intellectual Property Collateral"), as collateral security for the prompt and complete payment and performance when due (whether at the stated maturity, by acceleration, or otherwise) of such Grantor's First Lien Obligations:

(a) (i) All copyrights in Works, Software, moral rights, *sui generis* rights, database protection rights, or other rights of authors, whether or not the underlying works of authorship have been published, and all works of authorship and other intellectual property rights therein, all copyrights of works based on, incorporated in, derived from, or relating to works covered by such copyrights, all right, title, and interest to make and exploit all derivative works based on or adopted from works covered by such copyrights, and all copyright registrations and copyright applications, and any renewals or extensions thereof, including, without limitation, each registration and application identified in Schedule 1; (ii) the rights to print, publish and distribute any of the foregoing; (iii) the right to sue, defend, or otherwise recover for any and all past, present, and future actual or threatened infringements and misappropriations thereof, including action by any Governmental Authority; (iv) all income, royalties, damages, and other payments now and hereafter due or payable with respect thereto (including, without limitation, payments under all licenses entered into in connection therewith, and damages

and payments for past, present or future infringements thereof); and (v) all other rights of any kind whatsoever of such Grantor accruing thereunder or pertaining thereto ("Copyrights");

(b) (i) All trade secrets and all confidential and proprietary information, including know-how, manufacturing and production processes and techniques, software tools, algorithms, source and object codes, documentation, inventor notes, inventions, research and development information, technical data, financial, marketing, and business data, pricing and cost information, business and marketing plans, and customer and supplier lists and information, including, without limitation, any of the foregoing identified in Schedule 1; (ii) the right to sue or otherwise recover for any and all past, present, and future infringements and misappropriations thereof; (iii) all income, royalties, damages, and other payments now and hereafter due or payable with respect thereto (including, without limitation, payments under all licenses entered into in connection therewith, and damages and payments for past, present, or future infringements thereof), and (iv) all other rights of any kind whatsoever of such Grantor accruing thereunder or pertaining thereto (collectively, the "Trade Secrets");

(c) All licenses or agreements, whether written or oral, providing for the grant by or to any Grantor of: (i) any right to use any Copyright or Trade Secret; (ii) any right under any Copyright including, without limitation, the grant of rights to manufacture, distribute, exploit, and sell materials derived from any Copyright, including, without limitation, any of the foregoing identified in Schedule 1; (iii) the right to sue or otherwise recover for any and all past, present, and future infringements and misappropriations of any of the foregoing; (iv) all income, royalties, damages, and other payments now and hereafter due or payable with respect thereto (including, without limitation, payments under all licenses entered into in connection therewith, and damages and payments for past, present, or future infringements thereof); and (v) all other rights of any kind whatsoever of such Grantor accruing thereunder or pertaining thereto; and

(d) Any and all proceeds of the foregoing.

2. Grant of Security Interest for Second Lien Secured Parties. It being expressly understood and agreed that the security interests granted in this Agreement for the benefit of the Second Lien Secured Parties shall be subject to the provisions of the Intercreditor Agreement, each Grantor hereby grants to the Administrative Agent, for the ratable benefit of the Second Lien Secured Parties, a continuing security interest in and second priority Lien on all of such Grantor's rights, title, and interests in the Intellectual Property Collateral, as collateral security for the prompt and complete payment and performance when due (whether at the stated maturity, by acceleration, or otherwise) of such Grantor's Second Lien Obligations; *provided, however*, that the Liens granted pursuant to this section shall be subject and subordinate to the Liens granted to secure the First Lien Obligations pursuant to the preceding Section 1 and subject to the provisions of the Intercreditor Agreement.

3. Recordation. Each Grantor authorizes and requests that the Register of Copyrights and any other applicable government office record this Agreement.

4. Conflict Provision. This Agreement has been entered into in conjunction with the provisions of the Guarantee and Collateral Agreement, the Intercreditor Agreement, and the Credit Agreement. The rights and remedies of each party to this Agreement with respect to the security interests granted in this Agreement are without prejudice, and are in addition, to those set forth in the Guarantee and Collateral Agreement, the Intercreditor Agreement, and the Credit Agreement, all terms and provisions of which are incorporated herein by reference. In the event that any provisions of this Agreement are in conflict with the Guarantee and Collateral Agreement, the Intercreditor Agreement, or the Credit Agreement, the provisions of the Guarantee and Collateral Agreement, the Intercreditor Agreement, or the Credit Agreement (as the case may be) shall govern.

5. Administrative Agent May Perform. If any Grantor fails to perform any agreement contained herein, the Administrative Agent may itself perform, or cause performance of, such agreement, and the expenses of the Administrative Agent incurred in connection therewith shall be payable by Grantors under Section 10.

6. Further Assurances. Each Grantor shall, at any time and from time to time, and at its expense, make, execute, acknowledge and deliver, and file and record as necessary or appropriate with Governmental Authorities, such agreements, assignments, documents, and instruments, and do such other and further acts and things (including, without limitation, obtaining consents of third parties), as the Administrative Agent may request and as may be reasonably necessary or appropriate in order to implement and effect fully the intentions, purposes, and provisions of this Agreement, or to assure and confirm to the Administrative Agent the grant, perfection, and priority of the Administrative Agent's security interests in the Copyright and Trade Secret Collateral.

7. Termination. On the indefeasible payment in full in cash of the Obligations (other than Obligations that are contingent and unliquidated and not due and owing on such date and that, under the provisions of the Credit

Agreement or the other Loan Documents, survive the termination of the Credit Agreement or the repayment of the Obligations), this Agreement shall terminate and the Administrative Agent shall, on the written request and at the expense of the respective Grantors, execute and deliver to such Grantors all deeds, assignments, and other instruments as may be necessary or proper to reassign and reconvey to and re-vest in the Grantors the entire right, title, and interest to the Copyright and Trade Secret Collateral previously granted, assigned, transferred, and conveyed to the Administrative Agent by the Grantors under this Agreement, as fully as if this Agreement had not been made, subject to any disposition of all or any part thereof that may have been made by the Administrative Agent under this Agreement or the Guarantee and Collateral Agreement.

8. Expenses. Any and all fees, costs, and expenses, of whatever kind or nature, including reasonable attorney fees and expenses incurred by the Administrative Agent in connection with the preparation of this Agreement and all other documents relating hereto, the consummation of the transactions contemplated hereby, or the enforcement hereof, the filing or recording of any documents (including all taxes in connection therewith) in public offices, the payment or discharge of any taxes, counsel fees, maintenance or renewal fees, encumbrances, or otherwise protecting, maintaining, or preserving the Copyright and Trade Secret Collateral, or in defending or prosecuting any actions or proceedings arising out of or related to the Copyright and Trade Secret Collateral, shall be borne and paid by the Grantors.

9. Overdue Amounts. Until paid, all amounts due and payable by the Grantors under this Agreement shall be a debt secured by the Copyright and Trade Secret Collateral and other Collateral and shall bear, whether before or after judgment, interest at the rate of interest after an Event of Default set forth in the Credit Agreement.

10. No Assumption of Liability; Indemnification. NOTWITHSTANDING ANYTHING TO THE CONTRARY IN THIS AGREEMENT, NEITHER THE ADMINISTRATIVE AGENT NOR ANY OTHER SECURED PARTY ASSUMES ANY LIABILITIES OF ANY GRANTOR WITH RESPECT TO ANY CLAIM OR CLAIMS REGARDING SUCH GRANTOR'S OWNERSHIP OR PURPORTED OWNERSHIP OF, OR RIGHTS OR PURPORTED RIGHTS ARISING FROM, ANY OF THE COPYRIGHT AND TRADE SECRET COLLATERAL OR ANY USE, LICENSE, OR SUBLICENSE THEREOF, WHETHER ARISING OUT OF ANY PAST, CURRENT, OR FUTURE EVENT, CIRCUMSTANCE, ACT, OR OMISSION OR OTHERWISE. ALL OF SUCH LIABILITIES SHALL BE EXCLUSIVELY THE RESPONSIBILITY OF SUCH GRANTOR, AND SUCH GRANTOR SHALL INDEMNIFY THE ADMINISTRATIVE AGENT AND THE OTHER SECURED PARTIES FOR ANY AND ALL COSTS, EXPENSES, DAMAGES, AND CLAIMS, INCLUDING LEGAL FEES, INCURRED BY THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED PARTY WITH RESPECT TO SUCH LIABILITIES; *PROVIDED*, *HOWEVER,* THAT NOTHING HEREIN SHALL LIMIT ANY DUTY THAT THE ADMINISTRATIVE AGENT OR ANY OTHER SECURED PARTY MAY HAVE UNDER APPLICABLE LAW TO ACT IN A COMMERCIALLY REASONABLE MANNER.

11. Notices. All notices and other communications under or related to this Agreement shall be made and, unless otherwise specifically provided herein, shall be deemed to have been duly made or given in the manner set forth in Section ___ of the Credit Agreement.

12. Amendment and Waiver. This Agreement is subject to modification only by a writing signed by the Administrative Agent and the Grantors, and otherwise in accordance with Section ___ of the Credit Agreement and the provisions of the Intercreditor Agreement. No party to this Agreement shall be deemed to have waived any right under this Agreement unless such waiver shall be in writing and signed by the waiving party and otherwise in accordance with Section ___ of the Credit Agreement and the provisions of the Intercreditor Agreement. A waiver on any one occasion shall not be construed as a bar to or waiver of any right on any future occasion.

13. Governing Law; Consent to Jurisdiction. THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAW OF THE STATE OF NEW YORK, WITHOUT REGARD TO ITS CONFLICT OF LAW PROVISIONS.

14. Waiver of Jury Trial. EACH GRANTOR AND, BY ACCEPTANCE OF THE BENEFITS HEREOF, EACH SECURED PARTY HEREBY IRREVOCABLY AND UNCONDITIONALLY WAIVES TRIAL BY JURY IN ANY LEGAL ACTION OR PROCEEDING RELATING TO THIS AGREEMENT OR ANY OTHER LOAN DOCUMENT AND FOR ANY COUNTERCLAIM THEREIN.

15. Miscellaneous. The headings of each section of this Agreement are for convenience only and shall not define or limit the provisions thereof. This Agreement and all rights and obligations hereunder shall be binding on each Grantor and its respective successors and assigns, and shall inure to the benefit of the Administrative Agent, the other Secured Parties, and their respective successors and assigns. If any term of this Agreement shall be held to be invalid, illegal, or unenforceable, the validity of all other terms hereof shall in no way be affected thereby, and this Agreement shall be construed and be enforceable as if such invalid, illegal, or unenforceable term had not been included herein. Each Grantor acknowledges receipt of a copy of this Agreement.

16. Administrative Agent as Agent. The Administrative Agent has been appointed to act as Administrative Agent hereunder by the Lenders. The Administrative Agent shall be obligated, and shall have the right hereunder, to make demands, to give notices, to exercise or refrain from exercising any rights, and to take or refrain from taking any action (including, without limitation, the release or substitution of Collateral), solely in accordance with the Loan Documents, and in all cases subject to the provisions of the Intercreditor Agreement. The Administrative Agent shall at all times be the same Person that is the Administrative Agent under the Credit Agreement.

17. Execution in Counterparts. This Agreement may be executed in any number of counterparts (including by telecopy), each of which when so executed shall be deemed to be an original and all of which taken together shall constitute one and the same agreement.

IN WITNESS WHEREOF, this Agreement has been executed as of the day and year first above written.

Grantor 1:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgement*]

Grantor 2:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgement*]

Administrative Agent:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgement*]

SCHEDULE 1
TO
COPYRIGHT AND TRADE SECRET
COLLATERAL SECURITY AGREEMENT

[*To be completed by the Borrower*]

INTELLECTUAL PROPERTY

[*Add description of copyrights and trade secrets*]

EXHIBIT 1
TO
COPYRIGHT AND TRADE SECRET
COLLATERAL SECURITY AGREEMENT

ASSIGNMENT OF COPYRIGHTS

WHEREAS, _ _[*name*]_ _, a corporation organized and existing under the laws of the State of _ _[*e.g., California*]_ _ ("Assignor 1"), having a place of business at _ _[*address*]_ _, and _ _[*name*]_ _, a corporation

organized and existing under the laws of the State of _ _[*e.g., California*]_ _ ("Assignor 2"), having a place of business at _ _[*address*]_ _ (collectively the "Assignors"), are the owners of the Copyrights identified on the Annex hereto (the "Copyrights");

WHEREAS, _ _[*name*]_ _, having a place of business at _ _[*address*]_ _ (the "Assignee"), is desirous of acquiring the Copyrights;

WHEREAS, the Assignors and the Assignee have entered into that certain Copyright and Trade Secret Collateral Security Agreement, dated as of _ _[*date*]_ _ (as may be amended, restated, supplemented, or otherwise modified from time to time, the "Copyright Collateral Agreement");

NOW, THEREFORE, for good and valuable consideration, receipt of which is hereby acknowledged, the Assignors do hereby agree as follows:

1. DEFINITIONS

1.1. Terms Defined in the Copyright Collateral Agreement, the Credit Agreement, and the Guarantee and Collateral Agreement. All capitalized terms used in this Agreement and not otherwise defined herein shall have the meanings assigned to them in the Copyright Collateral Agreement and, if not therein defined, in the Guarantee and Collateral Agreement and, if not therein defined, in the Credit Agreement.

1.2. Certain Defined Terms. As used in this Agreement, the following terms shall have the following meanings:

"Copyright Licenses" means all licenses or agreements, whether written or oral, providing for the grant by or to any Grantor of: (i) any right under any Copyright including, without limitation, the grant of rights to manufacture, distribute, exploit, and sell materials derived from any Copyright, including, without limitation, any of the foregoing identified in Schedule 1; (ii) the right to sue or otherwise recover for any and all past, present, and future infringements and misappropriations of any of the foregoing; (iii) all income, royalties, damages, and other payments now and hereafter due or payable with respect thereto (including, without limitation, payments under all licenses entered into in connection therewith, and damages and payments for past, present, or future infringements thereof); and (iv) all other rights of any kind whatsoever of such Grantor accruing thereunder or pertaining thereto.

"Copyrights" means (i) copyrights in Works, Software, moral rights, *sui generis* rights, database protection rights, or other rights of authors, whether or not the underlying works of authorship have been published, and all works of authorship and other intellectual property rights therein, all copyrights of works based on, incorporated in, derived from, or relating to works covered by such copyrights, all right, title, and interest to make and exploit all derivative works based on or adopted from works covered by such copyrights, and all copyright registrations and copyright applications, and any renewals or extensions thereof, including, without limitation, each registration and application identified in Schedule 1; (ii) the rights to print, publish, and distribute any of the foregoing; (iii) the right to sue, defend, or otherwise recover for any and all past, present, and future actual or threatened infringements and misappropriations thereof, including action by any Governmental authority; (iv) all income, royalties, damages, and other payments now and hereafter due or payable with respect thereto (including, without limitation, payments under all licenses entered into in connection therewith, and damages and payments for past, present, or future infringements thereof); and (v) all other rights of any kind whatsoever of such Grantor accruing thereunder or pertaining thereto ("Copyrights");

"Escrowed Software" means all of the proprietary source code that is owned, developed, improved, or used by each Grantor in connection with the operation of its business, including, without limitation, the source code related to the processes that make the _ _[*description of manufactured products*]_ _ and the source code that is used to _ _[*description of specialized process*]_ _, including all versions, modifications, toolkits, and documentation related thereto (as the same may be updated or modified by or on behalf of any Grantor from time to time).

"Software" means all (i) computer programs; (ii) computer databases (including, but not limited to, databases used in conjunction with such computer programs); and (iii) documentation, specifications, manuals, and materials associated therewith, including Escrowed Software and similar development, design, process, or manufacturing software tools and took kits.

"Trade Secret Licenses" means all agreements (whether or not in writing) providing for the grant by or to any Grantor of any right to use any Trade Secret, including any of the foregoing referred to in Schedule 6.

"Trade Secrets" means all trade secrets and all other confidential or proprietary information and know-how, whether or not reduced to writing or any other tangible form, including all documents and things embodying, incorporating, or describing the foregoing, together with the right to sue for past, present, and future

misappropriations thereof and all proceeds of the foregoing.

"Work" means any document, Software, material, information, database, or other "work" as such term is defined in the U.S. Copyright Act of 1976, as amended, and any translations, modifications, derivative works, combinations, compilations, or components of the foregoing.

2. ASSIGNMENT

Each Grantor grants, assigns, transfers, conveys, and sets over to the Assignee such Grantor's entire right, title, and interest in its Copyrights throughout the world in perpetuity along with any media currently existing or developed hereafter, together with (i) the Copyright Registrations identified on the Annex attached hereto and incorporated herein by reference, (ii) the goodwill of the business symbolized by and associated with the Copyrights, and (iii) the right to sue and recover for, and the right to profits or damages due or accrued arising out of or in connection with, any and all past, present, or future infringements of, dilution of, damage to, or injury to the Copyrights or such associated goodwill.

This Assignment of Copyrights is intended to and shall take effect at such time as the Assignee shall complete this instrument by signing its acceptance of this Assignment of Copyrights below.

IN WITNESS WHEREOF, the Assignors, by their duly authorized officers, have executed this assignment on _ _[*date*]_ _**.**

Assignor 1:

_ _[*NAME OF CORPORATION*]_ _**,**
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Assignor 2:

_ _[*NAME OF CORPORATION*]_ _**,**
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgements*]

The foregoing assignment of the Copyrights by the Assignor to the Assignee is hereby accepted as of _ _[*date*]_ _**.**

Administrative Agent:

_ _[*NAME OF CORPORATION*]_ _**,**
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgement*]

ANNEX
TO
ASSIGNMENT OF COPYRIGHTS

[*To be completed by the Borrower*]

COPYRIGHT REGISTRATIONS

Copyright	**Registrations: United States Copyright Office**

	Registration No.	Registration Date

© The Regents of the University of California

Appendix D-4

Software Escrow Agreement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

SOFTWARE ESCROW AGREEMENT

Deposit Account Number _ _[*number*]_ _

This Software Escrow Agreement ("Agreement") is dated as of _ _[*date*]_ _**, among** _ _[*name*]_ _ **("Client"); and** _ _[*name*]_ _**, a** _ _[*e.g., California corporation*]_ _ **("Depositor 1"); and** _ _[*name*]_ _**, a** _ _[*e.g., California corporation*]_ _ **("Depositor 2," and, together with Depositor 1, the "Depositors"), in favor of** _ _[*name*]_ _**, as Administrative Agent (in such capacity, the "Administrative Agent") for the banks, financial institutions, and other entities (the "Lenders") from time to time parties to the Credit Agreement, dated as of** _ _[*date*]_ _ **(as amended, supplemented, or otherwise modified from time to time (the "Credit Agreement"). Unless otherwise specified, all references to the Administrative Agent herein shall include references to the Administrative Agent in its capacities as First Lien Agent and as Second Lien Agent. The signatories to this Agreement may be collectively referred to in this Agreement as the parties ("Parties"), or individually as a party ("Party").**

RECITALS

A. The Depositors have entered into a Credit Agreement dated as of the date of this Agreement (as amended, supplemented, amended, and restated, or otherwise modified, and in effect from time to time, the "Credit Agreement") and a Guarantee and Collateral Agreement (referred to in this Agreement as the "Guarantee and Collateral Agreement") among the Depositors, the Lenders party thereto, _ _[*name*]_ _, as sole lead arranger and sole book manager, and the Administrative Agent. All capitalized terms used in this Agreement and not otherwise defined herein shall have the meanings assigned to them in the Credit Agreement and, if not therein defined, in the Guarantee and Collateral Agreement.

B. The Depositors intend to secure the First Lien Obligations and any future First Lien Debt on a first priority basis and, subject to such priority, the Second Lien Obligations and any future Second Lien Debt on a second priority basis, with Liens on all present and future Collateral to the extent that such Liens have been provided for in the applicable Security Documents.

C. Depositors desire to avoid disclosure of their proprietary technology except under certain limited circumstances.

D. Under Section ____ of the Credit Agreement, Depositors are required to deliver all Escrowed Software source codes, all Escrowed Software source code-related documentation, and all patent, trademark, and copyright assignments as a prerequisite of each Lender's obligations to make its respective extensions of credit to the Depositors under the Credit Agreement.

E. Depositors and Administrative Agent desire to establish an escrow with Client to provide for the retention, administration, and controlled access of the proprietary technology materials of Depositors.

F. The Parties desire this Agreement to be supplementary to the Guarantee and Collateral Agreement under 11 United States Code §365(n).

1. DEPOSITS

1.1. Obligation to Make Deposit. Within 30 days after the Closing Date, Depositor shall deliver to Client, in accordance with Section ____ of the Credit Agreement, all Escrowed Software source codes, Escrowed Software source code-related documentation, and all patent, trademark, and copyright assignments (the "Deposit Materials").

1.2. Identification of Tangible Media. Before delivery of the Deposit Materials to Client, Depositor shall conspicuously label for identification each document, magnetic tape, disk, or other media on which the Deposit Materials are written or stored. Additionally, Depositor shall complete Exhibit B to this Agreement by listing each such media by the item label description, the type of media, and the quantity. Exhibit B shall be signed by Depositor and delivered to Client with the Deposit Materials. Unless and until Depositor makes the initial deposit with Client, Client shall have no obligation with respect to this Agreement, except the obligation to notify the parties regarding the status of the account as required in Section 2.2.

1.3. Acceptance of Deposit. When Client receives the Deposit Materials and Exhibit B, Client will conduct a visual deposit inspection. At completion of the deposit inspection, if Client determines that the labeling of the media matches the item descriptions and quantity on Exhibit B, Client shall date and sign Exhibit B and mail a copy thereof to Depositor and Administrative Agent. If Client determines that the labeling does not match the item descriptions or quantity on Exhibit B, Client shall (a) note the discrepancies in writing on Exhibit B; (b) date and sign Exhibit B with the exceptions noted; and (c) mail a copy of Exhibit B to Depositor and Administrative Agent. Client's acceptance of the deposit occurs on the signing of Exhibit B by Client. Delivery of the signed Exhibit B to Administrative Agent is Administrative Agent's notice that the Deposit Materials have been received and accepted by Client. OTHER THAN CLIENT'S INSPECTION OF THE DEPOSIT MATERIALS, AS DESCRIBED ABOVE, CLIENT SHALL HAVE NO OBLIGATION REGARDING THE ACCURACY, COMPLETENESS, FUNCTIONALITY, PERFORMANCE, OR NONPERFORMANCE OF THE DEPOSIT MATERIALS.

1.4. Depositor's Representations. During the term of this Agreement, Depositor represents as follows:

a. Depositor lawfully possesses all of the Deposit Materials deposited with Client;

b. With respect to all of the Deposit Materials and any materials provided solely for verification, under Section 1.5 ("Test Materials"), Depositor has the right and authority to grant to Client and Administrative Agent the rights as provided in this Agreement, provided that Client's or its independent contractor's use of any Deposit Materials or Test Materials under Section 1.5 is lawful and does not violate the rights of any third parties;

c. As of the effective date of this Agreement, except as set forth in the Credit Agreement, the Deposit Materials are not the subject of any liens or encumbrances; however, any liens or encumbrances made after the execution of this Agreement will not prohibit, limit, or alter the rights and obligations of Client under this Agreement;

d. The Deposit Materials consist of the proprietary technology and other materials identified either in the Guarantee and Collateral Agreement, Exhibit A, or Exhibit B, as the case may be; and

e. The Deposit Materials are readable and useable in their current form or, if any portion of the Deposit Materials is encrypted, the decryption tools and decryption keys have also been deposited.

1.5. Available Verification Services. On receipt of a written request from Administrative Agent, Client and Administrative Agent may enter into a separate proposal agreement ("Statement of Work") under which Client shall agree, on certain terms and conditions, to inspect the Deposit Materials consistent with one or several of the levels of verification described in the attached Technical Verification Options. Depositor consents to Client's performance of any level(s) of verification described in the attached Technical Verification Options. Depositor shall reasonably cooperate with Client by providing its facilities, computer software systems, and technical and support personnel for verification whenever reasonably necessary. If a verification is elected after the Deposit Materials have been delivered to Client, then only Client, or at Client's election, an independent contractor or company selected by Client may perform the verification.

1.6. Deposit Updates. Unless otherwise provided by the Guarantee and Collateral Agreement, Depositor shall update the Deposit Materials at least every 6 months or within 60 days of each release of a new version of the product that is subject to the Guarantee and Collateral Agreement. A release of a new version of software shall include the utilization of improved software for production purposes. Such updates shall be added to the existing deposit. All deposit updates shall be listed on a new Exhibit B, and Depositor shall sign the new Exhibit B. Each Exhibit B shall be held and maintained separately within the escrow account. An independent record shall be created, which will document the activity for each Exhibit B. Any deposit updates shall be held in accordance with Sections 1.2 through 1.4. All references in this Agreement to the Deposit Materials shall

include the initial Deposit Materials and any updates.

1.7. Removal of Deposit Materials. The Deposit Materials may be removed or exchanged only on written instructions signed by Depositor and Administrative Agent, or as otherwise provided in this Agreement.

2. CONFIDENTIALITY AND RECORDKEEPING

2.1. Confidentiality. Client shall have the obligation to reasonably protect the confidentiality of the Deposit Materials. Except as provided in this Agreement or any subsequent agreement between the Parties, including without limitation Section 1.5, Client shall not disclose, transfer, make available, or use the Deposit Materials. Client's independent contractors shall be subject to appropriate confidentiality restrictions with Client. Client shall not disclose the terms of this Agreement to any third party. If Client receives a subpoena or any other order from a court or other judicial tribunal pertaining to the disclosure or release of the Deposit Materials, Client shall immediately notify the parties to this Agreement unless prohibited by law. It shall be the responsibility of Depositor or Administrative Agent to challenge any such order; provided, however, that Client does not waive its rights to present its position with respect to any such order. Client shall not be required to disobey any order from a court or other judicial tribunal, including, but not limited to, notices delivered under Section 7.6.

2.2. Status Reports. Client shall provide to Depositor and Administrative Agent a report profiling the account history semiannually.

3. RIGHT TO MAKE COPIES.

Client shall have the right to make copies of the Deposit Materials as reasonably necessary to perform this Agreement. Client shall copy all copyright, nondisclosure, and other proprietary notices and titles contained on the Deposit Materials onto any copies made by Client. With all Deposit Materials submitted to Client, Depositor shall provide any and all instructions as may be necessary to duplicate the Deposit Materials, including, but not limited to, the hardware or software needed. Any copying expenses incurred by Client as a result of a request to copy shall be borne by the party requesting the copies. Alternatively, Client may notify Depositor requiring its reasonable cooperation in promptly copying the Deposit Materials in order for Client to perform this Agreement.

4. RELEASE OF DEPOSIT

4.1. Release Conditions. As used in this Agreement, "Release Condition" shall mean the following:

a. If an Event of Default specified in Section ____ of the Credit Agreement occurs with respect to any Depositor, the Deposit Materials shall be automatically released to the Administrative Agent.

b. If any other Event of Default occurs, with the consent of the Required Lenders, the Administrative Agent may, or on the request of the Required Lenders, the Administrative Agent shall, by notice to the Depositor, declare the loans due and payable in accordance with Section ___ of the Credit Agreement, thereby triggering the automatic release of the Deposit Materials to the Administrative Agent.

c. Any change in the environment in which the research and development is conducted or the regulatory laws of the United States or any foreign jurisdiction, including without limitation the People's Republic of China, that could reasonably be expected to have a Material Adverse Effect or otherwise materially adversely affect the Administrative Agent's rights in and to the Deposit Materials; or

d. Joint written instructions from Depositor and Administrative Agent.

4.2. Filing for Release. If Administrative Agent believes in good faith that a Release Condition has occurred, Administrative Agent may provide to Client written notice of the occurrence of the Release Condition and a request for the release of the Deposit Materials. Such notice shall be signed by the Administrative Agent and on company letterhead. Unless Client acknowledges or discovers independently, or through the Parties, its need for additional documentation or information in order to comply with this Section, Client shall promptly provide a copy of the notice to Depositor by commercial express mail. Such need for additional documentation or information may extend the time period for Client's performance under this Section.

4.3. Contrary Instructions. Except in the event of occurrence of a Release Condition that is automatic, as provided in Section 4.1(a) and (b), from the date Client mails the notice requesting release of the Deposit Materials, Depositor shall have 10 business days to deliver to Client contrary instructions ("Contrary Instructions"). Contrary Instructions shall mean the written representation by Depositor that a Release Condition has not occurred or has been cured. Contrary Instructions shall be signed by Depositor and on company letterhead. On receipt of Contrary Instructions, Client shall promptly send a copy to Administrative Agent by commercial express mail. Additionally, Client shall notify both Depositor and Administrative Agent that there is a dispute to be resolved under Section 7.4. Subject to Section 5.2, Client shall continue to store the Deposit Materials without release pending: (a) joint instructions from Depositor and Administrative Agent; (b) dispute resolution under Section 7.4; or (c) an order from a court of competent jurisdiction.

4.4. Release of Deposit. Except in the event of occurrence of a Release Condition that is automatic, as provided in Section 4.1(a) and (b), if Client does not receive Contrary Instructions from the Depositor, Client is authorized to release the Deposit Materials to the Administrative Agent or, if more than one beneficiary is registered to the deposit, to release a copy of the Deposit Materials to the Administrative Agent. However, Client is entitled to receive any fees due Client before making the release. Any copying expenses will be chargeable to Depositor. This Agreement will terminate on the release of the Deposit Materials held by Client.

4.5. Right to Use Following Release. Unless otherwise provided in the Guarantee and Collateral Agreement, on release of the Deposit Materials in accordance with this Article 4, Administrative Agent shall have the right to use the Deposit Materials for the sole purpose of enforcing its rights under the Credit Agreement, the Guarantee and Collateral Agreement, the Patent Collateral Security and Pledge Agreement, and the Copyright and Trade Secret Collateral Security Agreement.

5. TERM AND TERMINATION

5.1. Term of Agreement. This Agreement shall commence on the Closing Date and terminate on the earliest of: (a) _ _[*date*]_ _; (b) when both parties notify Client in a signed writing that the Agreement is terminated; (c) Client instructs Depositor and Administrative Agent in writing that the Agreement is terminated for nonpayment in accordance with Section 5.2; or (d) Client's termination of this Agreement, for any reason other than for nonpayment, by providing Depositor and Administrative Agent 60 days' prior written notice of its intent to terminate this Agreement.

5.2. Termination for Nonpayment. In the event of the nonpayment of fees owed to Client, Client shall provide written notice of delinquency to all parties to this Agreement. Any party to this Agreement shall have the right to make the payment to Client to cure the default. If the past due payment is not received in full by Client within 1 month of the date of such notice, then Client shall have the right to terminate this Agreement at any time thereafter by sending written notice of termination to all parties. Client shall have no obligation to take any action under this Agreement as long as any payment due to Client remains unpaid.

5.3. Disposition of Deposit Materials on Termination. Subject to the foregoing termination provisions, on termination of this Agreement, Client shall destroy, return, or otherwise deliver the Deposit Materials in accordance with Depositor's instructions. If there are no instructions, Client may, at its sole discretion, destroy the Deposit Materials or return them to Depositor. Client shall have no obligation to destroy or return the Deposit Materials if the Deposit Materials are subject to another escrow agreement with Client or have been released to the Administrative Agent in accordance with Section 4.

5.4. Survival of Terms Following Termination. On termination of this Agreement, the following provisions of this Agreement shall survive: (a) the obligations of confidentiality with respect to the Deposit Materials; (b) the obligation to pay Client any fees and expenses due; (c) the provisions of Article 7; and (d) any provisions in this Agreement that specifically state they survive the termination of this Agreement.

6. CLIENT'S FEES

6.1. Fee Schedule. The Depositor shall be responsible for payment of all Client's fees. Client is entitled to be paid its standard fees and expenses applicable to the services provided. Client shall notify the Depositor regarding payment of Client's fees at least 60 days prior to any increase in fees. For any service not listed on Client's standard fee schedule, Client shall provide a quote before rendering the service, if requested.

6.2. Payment Terms. Client shall not be required to perform any service, including release of any Deposit

Materials under Article 4, unless the payment for such service and any outstanding balances owed to Client are paid in full. Initial fees are due on receipt of a signed contract or receipt of the Deposit Materials, whichever is earliest. Payments on all renewal and services invoices are due net 30 days from date of invoice. If invoiced fees are not paid, Client may terminate this Agreement in accordance with Section 5.2.

7. LIABILITY AND DISPUTES

7.1. Right to Rely on Instructions. Client may act in reliance on any instruction, instrument, or signature reasonably believed by Client to be genuine. Client may assume that any employee of a party to this Agreement who gives any written notice, request, or instruction has the authority to do so. Client shall not be required to inquire into the truth or evaluate the merit of any statement or representation contained in any notice or document. Client shall not be responsible for failure to act as a result of causes beyond the reasonable control of Client.

7.2. Indemnification. Depositor and Administrative Agent each agree to indemnify, defend, and hold harmless Client from any and all claims, actions, damages, arbitration fees and expenses, costs, attorney fees, and other liabilities ("Liabilities") incurred by Client relating in any way to this escrow arrangement, except when it is adjudged that Client acted with gross negligence or willful misconduct.

7.3. Limitation of Liability. In no event shall Client be liable for any incidental, indirect, special, exemplary, punitive, or consequential damages, including, but not limited to, damages (including loss of data, revenue, or profits), costs, or expenses (including legal fees and expenses), whether foreseeable or unforeseeable, that may arise out of or in connection with this Agreement; and in no event shall the collective liability of Client exceed ten times the fees paid under this Agreement. The foregoing limitation of liability does not apply with respect to any acts of gross negligence, personal injury claims, property damage claims (excluding the Deposit), or intellectual property infringement.

7.4. Dispute Resolution. Any dispute, difference, or question relating to or arising among any of the parties concerning the construction, meaning, effect, or implementation of this Agreement or any party hereof shall be submitted to and settled by arbitration by a single arbitrator chosen by the _ _[*state*]_ _ Regional Office of the American Arbitration Association in accordance with the Commercial Rules of the American Arbitration Association. The arbitrator shall apply _ _[*state*]_ _ law. Unless otherwise agreed by Depositor and Administrative Agent, arbitration shall take place in _ _[*city, state*]_ _, U.S.A. Any court having jurisdiction over the matter may enter judgment on the award of the arbitrator. Service of a petition to confirm the arbitration award may be made by first-class mail or by commercial express mail, to the attorney for the party or, if unrepresented, to the party at the last known business address. If, however, Depositor or Administrative Agent refuses to submit to arbitration, the matter shall not be submitted to arbitration and Client may submit the matter to any court of competent jurisdiction for an interpleader or similar action. Unless adjudged otherwise, any costs of arbitration incurred by Client, including reasonable attorney fees and costs, shall be divided equally and paid by Depositor and Administrative Agent.

7.5. Controlling Law. This Agreement is to be governed and construed in accordance with the laws of the State of New York, without regard to its conflict of law provisions.

7.6. Notice of Requested Order. If any party intends to obtain an order from the arbitrator or any court of competent jurisdiction that may direct Client to take, or refrain from taking, any action, that party shall:

a. Give Client at least 5 business days' prior notice of the hearing;

b. Include in any such order that, as a precondition to Client's obligation, Client shall be paid in full for any past due fees and be paid for the reasonable value of the services to be rendered under such order; and

c. Ensure that Client shall not be required to deliver the original (as opposed to a copy) of the Deposit Materials if Client needs to retain the original in its possession to fulfill any of its other duties.

8. GENERAL PROVISIONS

8.1. Entire Agreement. This Agreement, which includes Exhibits described in this Agreement, embodies the entire understanding among the parties with respect to its subject matter and supersedes all previous communications, representations, or understandings, either oral or written. Client is not a party to the Credit

Agreement or the Guarantee and Collateral Agreement between Depositor and Administrative Agent and has no knowledge of any of the terms or provisions of any such Agreements. Client's only obligations to Depositor or Administrative Agent are as set forth in this Agreement. No amendment or modification of this Agreement shall be valid or binding unless signed by all the parties hereto, except that Exhibit A need not be signed by Client, Exhibit B need not be signed by Administrative Agent, Exhibit C need not be signed, and the Statement of Work need only be executed by Client and Administrative Agent.

8.2. Notices and Correspondence. All notices, requests, and demands to or on any party to this Agreement to be effective shall be in writing, and, unless otherwise expressly provided herein, shall be deemed to have been duly given or made when delivered, or three Business Days after being deposited in the mail, postage prepaid, addressed as follows, in the case of Depositor, _ _[*name*]_ _ serving as the point of contact for all Depositor signatories to the Agreement, or to such other address as may be hereafter notified by the respective parties hereto:

Depositor: _ _[*Name*]_ _
_ _[*Address*]_ _
_ _[*Fax number*]_ _
_ _[*Telephone*]_ _

Administrative Agent: _ _[*Name*]_ _
_ _[*Address*]_ _
_ _[*Fax number*]_ _
_ _[*Telephone*]_ _

Client: _ _[*Name*]_ _
_ _[*Address*]_ _
_ _[*Fax number*]_ _
_ _[*Telephone*]_ _

provided that any notice, request, or demand to or on Administrative Agent shall not be effective until received.

8.3. Severability. If any provision of this Agreement is invalid, illegal, or unenforceable in any respect or in any jurisdiction, the validity, legality, and enforceability of such provision in all other respects and of all remaining provisions, and of such provision in all other jurisdictions, shall not in any way be affected or impaired thereby.

8.4. Successors and Assigns. Neither Depositor nor any other Pledgor may delegate any of its duties or assign any of its rights hereunder, and any attempted delegation or assignment of any such duties or rights shall be null and void. All obligations of the Depositor and the other Pledgors under this Agreement shall inure to the sole and exclusive benefit of, and be enforceable by, the Administrative Agent and each present and future holder of Secured Obligations, each of whom shall be entitled to enforce this Agreement as a third party beneficiary, and all of their respective successors and assigns. However, Client shall have no obligation in performing this Agreement to recognize any successor or assign of Depositor or Administrative Agent unless Client receives clear, authoritative, and conclusive written evidence of the change of parties.

8.5. Waiver. No failure to exercise, no course of dealing with respect to the exercise of, and no delay in exercising, any right, power, or remedy arising under this Agreement or any of the other Security Documents shall impair any such right, power, or remedy or operate as a waiver thereof. No single or partial exercise of any such right, power, or remedy shall preclude any other or future exercise thereof or the exercise of any other right, power, or remedy. The remedies in this Agreement are cumulative and are not exclusive of any remedies provided by law.

8.6. Regulations. Depositor and Administrative Agent are responsible for and warrant compliance with all applicable laws, rules, and regulations, including but not limited to, customs laws, import, export, and re-export laws, and government regulations of any country from or to which the Deposit Materials may be delivered in accordance with the provisions of this Agreement.

8.7. No Third Party Rights. Except as provided in Section 8.4, this Agreement is made solely for the benefit of the Parties to this Agreement and their respective permitted successors and assigns, and no other person or entity shall have or acquire any right by virtue of this Agreement unless otherwise agreed to by all the

parties hereto.

8.8. Authority to Sign. Each of the Parties herein represents and warrants that the execution, delivery, and performance of this Agreement has been duly authorized and signed by a person who meets statutory or other binding approval to sign on behalf of its business organization as named in this Agreement. Client will be able to perform its obligations under this Agreement once Client has received a fully executed Agreement.

8.9. Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be an original, but all of which together shall constitute one instrument.

IN WITNESS WHEREOF, the parties, by their duly authorized officers, have executed this Agreement on _ _[*date*]_ _**.**

Depositor 1:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Depositor 2:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Administrative Agent:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Client:

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Add applicable notarial acknowledgements*]

EXHIBIT A
TO
SOFTWARE ESCROW AGREEMENT

MATERIALS TO BE DEPOSITED

Deposit Account Number _ _[*number*]_ _

Depositor represents to Preferred Beneficiary that Deposit Materials delivered to Client shall consist of the

following:

All Escrowed Software source codes, Escrowed Software source code-related documentation, and all patent, trademark, and copyright assignments.

EXHIBIT B
TO
SOFTWARE ESCROW AGREEMENT

DESCRIPTION OF DEPOSIT MATERIALS

Depositor: _ _[*Company name and address*]_ _

Account Number: _ _[*Escrow account number*]_ _

Product Name: _ _[*Name of product as listed on Exhibit A*]_ _

Version: _ _[*Version number*]_ _

(Product Name will appear as the Exhibit B Name on Account History report)

Quantity	Media Type & Size	Label Description of Each Separate Item
_____	Disk 3.5" or ____	_____
_____	DAT tape ____mm	_____
_____	CD-ROM	_____
_____	Data cartridge tape ___	_____
_____	TK 70 or ____ tape	_____
_____	Magnetic tape ____	_____
_____	Documentation	_____
_____	Other _____	_____

PRODUCT DESCRIPTION:

Environment: _ _[*Describe*]_ _

DEPOSIT MATERIAL INFORMATION:

Is the media encrypted? _ _[*Yes/No*]_ _ **If yes, please include any passwords and the decryption tools.**

Encryption tool: _ _[*Name, version*]_ _

Hardware required: _ _[*Name*]_ _

Software required: _ _[*Name*]_ _

Other required information_____

I certify for Depositor that the above described Deposit Materials have been transmitted to Client:

Depositor 1:

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Client has visually inspected and accepted the above materials (any exceptions are noted above).

Client:

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Appendix D-5

Provisions for Additional Secured Party Rights Relating to Intellectual Property on Default

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Intellectual Property Litigation and Protection.

(a) On the occurrence and during the continuance of any Event of Default, the Administrative Agent shall have the right, but shall in no way be obligated, to file applications for the protection of the Intellectual Property and to bring suit in the name of any Grantor, the Administrative Agent, or the Secured Parties to protect or enforce the Intellectual Property and any Intellectual Property License. In the event of any such suit, each Grantor shall, at the reasonable request of the Administrative Agent, do any and all lawful acts and execute any and all documents requested by the Administrative Agent in aid of such enforcement, and the Grantors shall promptly reimburse and indemnify the Administrative Agent, as the case may be, for all costs and expenses incurred by the Administrative Agent in the exercise of its rights under this Section ____ in accordance with Section ____. In the event that the Administrative Agent elects not to bring suit to enforce the Intellectual Property, each Grantor agrees, at the reasonable request of the Administrative Agent, to take all commercially reasonable actions necessary, whether by suit, proceeding, or other action, to prevent the infringement, misappropriation, counterfeiting, unfair competition, dilution, diminution in value of, or other damage to any of the Intellectual Property by others and for that purpose agrees to diligently maintain any suit, proceeding, or other action against any Person so infringing necessary to prevent such infringement.

(b) On the occurrence and during the continuance of any Event of Default, and on written demand from the Administrative Agent, each Grantor shall grant, assign, convey, or otherwise transfer to the Administrative Agent or such Administrative Agent's designee all of such Grantor's right, title, and interest in and to the Intellectual Property and shall execute and deliver to the Administrative Agent such documents as are necessary or appropriate to carry out the intent and purposes of this Agreement. Within 5 Business Days after written notice from the Administrative Agent, each Grantor shall make available to the Administrative Agent, to the extent within such Grantor's power and authority, such personnel in such Grantor's employ or retention on the date of such Event of Default as the Administrative Agent may reasonably designate, by name, title, or job responsibility, to permit such Grantor to continue, directly or indirectly, to produce, advertise, and sell the products and services sold or delivered by such Grantor under or in connection with the Intellectual Property, such persons to be available to perform their prior functions on the Administrative Agent's behalf and to be compensated by the Administrative Agent at such Grantor's expense on a per diem, pro-rata basis consistent with the salary and benefit structure applicable to each as of the date of such Event of Default.

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Appendix D-6

Intellectual Property Representations and Warranties From Loan and Security Agreement

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To induce the Secured Parties to enter into the Credit Agreement and any Specified Hedge Agreement and to induce the Lenders to make their respective Loans to the Borrowers under the Credit Agreement, each Grantor hereby represents and warrants to each Secured Party that:

_ _[*§number*]_ _ **Intellectual Property (a) Schedule _ _[*number*]_ _ sets forth a true and complete list of (i) all United States and foreign registrations of and applications for Patents and Trademarks owned by each Grantor, (ii) all Intellectual Property Licenses granting to another Person rights in any material Patents, Trademarks, Copyrights, or Trade Secrets owned by such Grantor or granting to another Person, on an exclusive basis, rights in any Patents, Trademarks, Copyrights, or Trade Secrets owned by such Grantor, and (iii) all other Intellectual Property Licenses that are material to the business of such Grantor as presently conducted; provided, however, that Schedule _ _[*number*]_ _ need not list (1) Intellectual Property Licenses from one Grantor to another Grantor except for Excluded Foreign Subsidiaries, or (2) Intellectual Property Licenses for "off-the-shelf" Software used in the day-to-day business operations of such Grantor, provided that such Software was not custom written or custom modified by or on behalf of such Grantor and is not being misused by such Grantor, and provided that the amounts such Grantor is required to pay under such Intellectual Property License are immaterial. Such Grantor does not own any trademarks or service marks registered under the laws of a state of the United States or any copyrights registered with the U.S. Copyright Office; nor does such Grantor have any such state trademark or service mark applications for registration or applications for such Copyright registrations.**

(b) With respect to all registrations and applications required to be disclosed on Schedule _ _[*number*]_ _, (i) each Trademark registration or application for registration and each Patent application and issued Patent is in the name of such Grantor, (ii) with respect to each Trademark registration and issued Patent, such Grantor has performed all acts and paid all renewal, maintenance, and other fees and taxes required to maintain the same in effect in the United States and in each foreign jurisdiction where such Grantor has obtained any Trademark registration or issued Patent, (iii) as to each Trademark registration and issued Patent required to be listed on Schedule _ _[*number*]_ _ by virtue of clause (i) or (ii) of Section _ _[*§number*]_ _(a) above, that is material to the conduct of the business of any Grantor as presently conducted, each such Trademark registration and issued Patent is valid and enforceable, (iv) as to each registered Trademark and issued Patent which is the subject of an Intellectual Property License required to be listed on Schedule _ _[*number*]_ _ by virtue of clause (iii) of Section _ _[*§number*]_ _(a) above, to the knowledge of the Grantor after having made due inquiry, each such Trademark registration and issued Patent is valid and enforceable; and (v) except as set forth on Schedule _ _[*number*]_ _, such Grantor is the sole and exclusive owner of the entire right, title, and interest in and to all Intellectual Property owned by such Grantor that is material to the conduct of the business of any Grantor as presently conducted.

(c) Such Grantor owns or has the valid right to distribute, publicly perform, publicly display, reproduce, and prepare derivative works of the Works covered by Copyrights, which Works are used in the conduct the business of any Grantor as presently conducted, free and clear of all Liens, claims, encumbrances, and licenses, except for Permitted Liens and the Intellectual Property Licenses set forth on Schedule _ _[*number*]_ _ or not listed on Schedule _ _[*number*]_ _ by reason of clause (1) or (2) of Section _ _[*§number*]_ _ (a)(iii) above.

(d) (i) All Issued Patents that are licensed to such Grantor and are material to the conduct of the business of any Grantor as presently conducted are subsisting, valid, and enforceable, to the knowledge of the Grantor after having made due inquiry, and (ii) except as set forth on Schedule _ _[*number*]_ _, all Intellectual Property that is licensed to such Grantor and is material to the conduct of the business of any Grantor as presently conducted is the subject of an Intellectual Property License that is valid and enforceable in accordance with its

terms, which expressly permits such Grantor to mortgage and assign such Intellectual Property License to another party without the licensor's consent.

(e) All Trade Secrets owned by or licensed to such Grantor (and for which confidentiality is appropriate) have been maintained by each Grantor in confidence in accordance with protection procedures that are adequate for protection customarily used in the industry to protect rights of like importance.

(f) All former and current managers, employees, agents, consultants, and independent contractors who have contributed in any material way to or participated in any material way in the conception and development of such Grantor's Intellectual Property that is material to the business of any Grantor as presently conducted have executed and delivered to such Grantor a written agreement obligating them to keep information confidential, not to use confidential information for any unauthorized purpose, to assign or assigning (as applicable) all of their inventions and works of authorship to such Grantor, and acknowledging that their works of authorship are works made for hire, to the extent such agreements are material to the business or any Grantor as presently conducted.

(g) No former or current employee or independent contractor of such Grantor has asserted or threatened any claim against such Grantor in connection with such employee's or contractor's involvement in the conception and development of any of such Grantor's Intellectual Property.

(h) To the best of such Grantor's knowledge, none of the former or current shareholders, employees, directors, officers, or independent contractors of such Grantor owns any issued Patent or Patent application that would be infringed by the conduct of the business of any Grantor, as presently conducted.

(i) Except as set forth on Schedule _ _[*number*]_ _, no action or proceeding before any court or administrative authority is pending and served (or, to the best of such Grantor's knowledge, pending but not served), or to the best of such Grantor's knowledge, threatened, against such Grantor, in each case challenging the validity of, or challenging such Grantor's rights to own, use, or license to other parties, any Intellectual Property owned by such Grantor.

(j) Such Grantor has been using proper marking practices in connection with the use of Grantor's Patents and Trademarks, and appropriate notice of copyright in connection with the publication of Copyrights material to the business of such Grantor.

(k) Such Grantor uses adequate standards of quality in the manufacture, distribution, and sale of all products sold and in the provision of all services rendered under or in connection with all Trademarks owned by such Grantor and has taken all action necessary to ensure that all licensees of such Trademarks use such adequate standards of quality.

(l) The conduct of such Grantor's business as presently conducted does not: (i) infringe on, dilute, or misappropriate any Intellectual Property of any other Person; (ii) violate any term or provision of any Contractual Obligation concerning such Intellectual Property (including any provision required or imposed by 35 United States Code §§200-212 in any Contractual Obligation requiring that products be manufactured substantially in the United States); or (iii) constitute unfair competition or an unfair trade practice under any Requirement of Law, which matter described in clause (i), (ii), or (iii) could reasonably be expected to have a Material Adverse Effect. No claim of any matter described in clause (i), (ii), or (iii) above is pending and served (or, to the best of such Grantor's knowledge, pending but not served), or, to the best of such Grantor's knowledge, threatened, and such Grantor (including management-level employees of such Grantor with direct responsibility for Intellectual Property matters) has never received any charge, complaint, claim, demand, or notice alleging any such interference, infringement, misappropriation, or violation (including any claim that such Grantor must license or refrain from using any Intellectual Property rights of any other Person).

(m) To the best of such Grantor's knowledge and except as may have otherwise been discussed with counsel to the Administrative Agent, no other party is infringing on, diluting, or misappropriating any material Intellectual Property owned or used by such Grantor.

(n) Except as set forth on Schedule _ _[*number*]_ _, no licensing fees, royalties, or payments other than payments that are not significant in amount (either individually or in the aggregate) are due or payable by such Grantor in connection with the Intellectual Property.

(o) Such Grantor is not bound by any settlement, consent, or covenant not to sue that adversely affects such Grantor's rights to own or use, or to grant nonassertion assurance releases in respect of, any material Intellectual Property that could reasonably be expected to have a Material Adverse Effect.

(p) Such Grantor has not made any agreements or entered into any Contractual Obligation (other than this Agreement, and each Intellectual Property Security Agreement required by the terms of the Credit Agreement) to mortgage, pledge, encumber, assign, sell, transfer, license, or grant an option for any material Intellectual Property outside the ordinary course of business that has not been terminated or released.

(q) Schedule _ _[*number*]_ _ identifies all Software used in and material to the conduct of the business of any Grantor as presently conducted and includes the Escrowed Software ("Material Software").

(r) Escrowed Software source code and all documentation thereto is maintained safely and securely at the location indicated in Schedule _ _[*number*]_ _ and regularly updated to reflect any changes to the source code as they are made.

(s) Except as disclosed in Schedule _ _[*number*]_ _, the Escrowed Software source code has not been disclosed to any Person other than the Persons listed on Schedule _ _[*number*]_ _ in response to clause ___ below.

(t) Only the individuals identified on Schedule _ _[*number*]_ _ have access to the Escrowed Software source code.

(u) Such Grantor does not have possession of the source code to any Material Software other than the Escrowed Software.

(v) No Grantor has, directly or indirectly, transported or transmitted Material Software to the People's Republic of China or any other country in violation of any export or import control or other Requirement of Law.

(w) All former and current managers, employees, agents, consultants, and independent contractors of any Grantor who have authored, co-authored, or otherwise contributed to or participated in any material way in the conception and development of Material Software (each, an "IP Participant") have executed and delivered to such Grantor a proprietary information agreement, under which, inter alia, each such IP Participant has assigned any and all of his or her rights in such Intellectual Property to Seller and has agreed to keep such Material Software confidential and not to use such Material Software for any purpose unrelated to his or her work for such Grantor.

(x) No former or current IP Participant has filed, asserted in writing, or, to the best of such Grantor's knowledge (or employees of such Grantor with direct responsibility for Intellectual Property matters), threatened any claim against any Grantor in connection with his or her involvement in such Material Software.

_ _[*§number*]_ _ Source Code Escrow. On the date of this Agreement, each Grantor shall deposit into escrow, in accordance with the terms of that certain Software Escrow Agreement executed concurrently herewith (the "Escrow Agreement"), all of the proprietary source code that is owned, developed, improved, or used by each Grantor in connection with the operation of its business, including, without limitation, the source code related to the processes that make _ _[*description of manufactured product*]_ _ and the source code that is used to _ _[*description of specialized process*]_ _, including all versions, modifications, toolkits, and documentation related thereto (as the same may be updated or modified by or on behalf of any Grantor from time to time, the "Escrowed Software"). The Escrowed Software represents a complete listing of all of the proprietary source code that each Grantor considers to be useful and/or necessary to make the _ _[*description of manufactured product*]_ _ that are currently manufactured by each Grantor. The Escrowed Software includes all software that each Grantor considers to give it a competitive advantage over its competitors.

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Appendix D-7

Intellectual Property Covenants from Loan and Security Agreement

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Borrower covenants and agrees with the Agents and the Lenders that, from and after the date of this Agreement until the Secured Obligations shall have been paid in full:

_ _[*§number*]_ _ **Material Contracts**

(a) Borrower shall perform and comply in all material respects with all its obligations under the Material Contracts.

(b) Borrower shall not amend, modify, terminate, or waive any provision of any Material Contract in any manner that could reasonably be expected to materially adversely affect the value of such Material Contract as Collateral.

(c) Borrower shall exercise promptly and diligently each and every material right that it may have under each Material Contract (other than any right of termination).

(d) Borrower shall deliver to the Administrative Agent a copy of each material demand, notice, or document received by it relating in any way to any Material Contract that questions the validity or enforceability of such Material Contract.

(e) With respect to any Non-Assignable Contract, Borrower shall, within 30 days of the date of this Agreement, request in writing the consent of the counterparty or counterparties to the Non-Assignable Contract, under the terms of such Non-Assignable Contract or applicable law, to the assignment or granting of a security interest in such Non-Assignable Contract to the Administrative Agent and shall use its commercially reasonable efforts to obtain such consent as soon as practicable thereafter. After the date of this Agreement, Borrower shall not enter into any Material Contract that is a Non-Assignable Contract.

_ _[*§number*]_ _ **Intellectual Property**

(a) Borrower shall (i) to the extent consistent with good business judgment, continue to use each material Trademark on each and every trademark class of goods applicable to its current line and markets as reflected in its current catalogs, brochures, and price lists in order to maintain such Trademark in full force free from any claim of abandonment for non-use; (ii) maintain as in the past the quality of products and services offered under such Trademark; (iii) not adopt or use any mark that is confusingly similar to or a colorable imitation of such Trademark unless the Administrative Agent, for the ratable benefit of the Secured Parties, shall obtain a perfected security interest in such mark pursuant to this Agreement; and (iv) to the extent consistent with good business judgment, not (and not permit any licensee or sublicensee of any material Trademark to) do any act or knowingly omit to do any act by which such Trademark may become invalidated or impaired in any way.

(b) Other than with respect to Borrower's issued Patents and Patent applications that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall not take any action or fail to take any action, nor affirmatively permit any action, or failure of action, to be taken that would reasonably be expected to render any of Borrower's issued Patents invalid or unenforceable or terminate or allow to lapse any Patent application or adversely affect the validity, grant, or enforceability of the Secured Parties' security interest therein.

(c) Other than with respect to Borrower's Copyrights that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall not take any action or fail to take any action, nor affirmatively permit any action, or failure of action, to be taken that would reasonably be expected to result in Borrower's Copyrights (including Software) becoming part of the public domain or that would adversely affect the validity, grant, or enforceability of the Secured Parties' security interest therein.

(d) Other than with respect to Borrower's Trade Secrets that are not used in the business of Borrower as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take

responsive actions, Borrower shall not take any action or fail to take any action, nor affirmatively permit any action, or failure of action, to be taken that would reasonably be expected to result in Borrower's Trade Secrets (including Software source code) losing their status as trade secrets protected by state law or as confidential information covered by nondisclosure agreements or adversely affect the validity, grant, or enforceability of the Secured Parties' security interest therein.

(e) Other than with respect to such Intellectual Property Licenses that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall not take any action or fail to take any action, nor affirmatively permit any action, or failure of action, to be taken that would reasonably be expected to result in the termination, cancellation, nonrenewal, or adverse modification of any Intellectual Property License or adversely affect the validity, grant, or enforceability of the Secured Parties' security interest therein.

(f) Borrower shall not knowingly do any act that causes any Intellectual Property to infringe, misappropriate, or otherwise violate the Intellectual Property rights of any other Person.

(g) Other than with respect to Borrower's issued Patents and Patent applications that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall notify the Administrative Agent and the Lenders immediately if it knows, or has reason to know, that any of Borrower's issued Patents may be invalidated or rendered unenforceable or that any of Borrower's Patent applications may lapse or be rejected, or that any of Borrower's issued Patents or Patent Applications may be subject to any adverse determination or significant procedural development (including the institution of, or any such determination or development in, any proceeding in the United States Patent and Trademark Office, the United States Copyright Office or any court, tribunal, or agency in any country) regarding Borrower's ownership of, use of, or the validity of, any such issued Patent or, if applicable, Patent application.

(h) Other than with respect to Borrower's Trade Secrets that are not used in Borrower's business as presently conducted or the value of which (including Software source code) does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall notify the Administrative Agent and the Lenders immediately if it knows, or has reason to know, that any of Borrower's Trade Secrets (including Software source code) may lose their status as trade secrets protected by state law or cease to be covered by nondisclosure agreements or that any Software source code has been disclosed to any unauthorized Person or, in the case of the _ _[*description of specialty software*]_ _ software, to any Person other than the Persons identified on Schedule _ _[*number*]_ _ in response to Section _ _[*§number*]_ _(q)(iii) above.

(i) Whenever Borrower, either by itself or through any agent, employee, licensee, or designee, shall file a Patent application or application for Trademark registration with the United States Patent and Trademark Office, an application for Copyright registration with the United States Copyright Office, or any similar application with any similar office or agency in any other country or any political subdivision thereof, Borrower shall report such filing to the Administrative Agent, in the case of Patent applications and applications for Copyright registrations, no fewer than 5 Business Days before the date such filing is proposed to occur and, in the case of applications for Trademark registrations, no more than 15 Business Days after such filing has occurred (except in the case of applications sought on an expedited basis that could not reasonably have been sought at an earlier date, then as soon as reasonably practical thereafter). On request of the Administrative Agent, Borrower shall execute and deliver, and have recorded, any and all agreements, instruments, documents, and papers as the Administrative Agent may request to evidence (i) the First Lien Secured Parties' first priority security interest in, and (ii) the Second Lien Secured Parties' second priority security interest in, the Patent application or resulting registered Copyright or Trademark and the goodwill associated therewith, as the case may be, including all supplements and schedules thereto.

(j) Every 6 months, Borrower shall provide the Administrative Agent with a written description and true and correct copies of updates and modifications made by or on behalf of Borrower to the Escrowed Software.

(k) Other than with respect to Borrower's issued Patents and Patent applications that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, Borrower shall take all reasonable and necessary steps, including in any proceeding before the United States Patent and Trademark Office or any similar office or agency in any other country or group of countries or any political subdivision of any of the foregoing, to maintain and pursue each Patent application and issued Patent that is now or shall become included in the Collateral.

(l) Other than with respect to Borrower's Intellectual Property Licenses that are not used in Borrower's business as presently conducted or the value of which does not reasonably justify the cost of taking or failing to take responsive actions, in the event that Borrower becomes aware that any Intellectual Property License owned by Borrower is infringed, misappropriated, or diluted by another Person, Borrower shall (i) promptly take all commercially reasonable actions to stop such infringement, misappropriation, or dilution, as

applicable, and to protect its rights in such Intellectual Property License and (ii) promptly notify the Administrative Agent thereof and take all commercially reasonable actions to sue for infringement, misappropriation, or dilution, to seek injunctive relief where appropriate, and to recover any and all damages for such infringement, misappropriation, or dilution.

(m) Other than with respect to Borrower's material Trade Secrets that are not used in Borrower's business as presently conducted, Borrower shall take all commercially reasonable steps required to protect the secrecy and proprietary nature of Borrower's Trade Secrets (including ongoing compliance with the provisions of Section _ _[*§number*]_ _(q)), including entering into confidentiality agreements with employees and independent contractors and labeling and restricting access to secret information and documents.

(n) Borrower shall promptly (but in no event more than 30 days after it become aware of the fact) report to the Administrative Agent the registration of any of Borrower's Intellectual Property by the United States Patent and Trademark Office, United States Copyright Office, or any state registry or foreign counterpart and shall concurrently with such report to the Administrative Agent execute and deliver to the Administrative Agent a completed Pledge Supplement, together with all supplements to the schedules thereto or a signed counterpart of a Trademark Security Agreement, or Patent Security Agreement, or Copyright Security Agreement, as applicable, together with all supplements to the schedules thereto.

(o) Except with the prior written consent of the Administrative Agent or as permitted under the Credit Agreement, Borrower shall not execute, and there shall not be on file in any public office, any financing statement or other document or instrument except financing statements or other documents or instruments filed or to be filed in favor of the Administrative Agent in connection with the Loan Documents, and Borrower shall not (i) outside the ordinary course of business, license, or grant an option to license, or (ii) sell, assign, transfer, grant any rights to another Person on an exclusive basis, grant any option, or create, or suffer to exist, any Lien on or with respect to the Intellectual Property that it owns or any Intellectual Property License, except for the Liens created by and under this Agreement and the other Loan Documents.

(p) Borrower shall use all commercially reasonable efforts so as not to permit the inclusion or absence, as applicable, in any contract to which it hereafter becomes a party of any provision, the inclusion or absence (as applicable) of which would impair or prevent the creation, perfection, or enforcement of a security interest in, or the assignment of, Borrower's rights and interests in any Intellectual Property acquired after the date of this Agreement.

(q) Borrower shall use appropriate notices in connection with its use of any material Intellectual Property owned by Borrower.

(r) Borrower shall, consistent with Section _ _[*§number*]_ _, continue to collect, at its own expense, all amounts due or to become due to Borrower in respect of any Intellectual Property. In connection with such collections, Borrower may take (and, at the Administrative Agent's reasonable direction, shall take) such action as Borrower or the Administrative Agent may deem reasonably necessary or advisable to enforce collection of such amounts. Notwithstanding the foregoing, the Administrative Agent shall have the right at any time, to notify or to require Borrower to notify, any obligors with respect to any such amounts of the existence of the security interest created hereby.

_ _[*§number*]_ _ **Commercial Tort Claims**

Borrower shall update Schedule _ _[*number*]_ _ such that all Commercial Tort Claims then in litigation, or in connection with which any filing or document (such as a "cease and desist" letter or similar document) has been made or delivered, are promptly listed thereon.

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Appendix D-8

Power of Attorney Provisions

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_ _[*§number*]_ _ **Power of Attorney. (a) Borrower hereby irrevocably constitutes and appoints Secured Party and any officer or agent of Secured Party, with full power of substitution, as Borrower's true and lawful attorney-in-fact with full irrevocable power and authority in Borrower's place and stead and in Borrower's name or in Secured Party's own name, for the purpose of carrying out the terms of this Agreement, to take any and all appropriate action, and to execute any and all documents and instruments that may be necessary or desirable to accomplish the purposes of this Agreement, and, without limiting the generality of the foregoing, Borrower hereby gives Secured Party the power and right, on behalf of Borrower, without notice to or assent by Borrower:**

(i) To execute and deliver, and have recorded, any and all agreements, instruments, documents, and papers as the Administrative Agent may request to evidence Secured Party's security interests in such intellectual property and the goodwill and general intangibles of Borrower relating thereto or represented thereby;

(ii) Assign or license any Copyright, Patent, or Trademark (along with the goodwill of the business to which any such Copyright, Patent, or Trademark pertains) throughout the world for such term or terms, on such conditions, and in such manner as the Secured Party shall in its sole discretion determine, and generally sell, transfer, pledge, make any agreement with respect to, or otherwise deal with any of the Collateral, as fully and completely as if the Administrative Agent were the absolute owner thereof for all purposes; and

(iii) Do, at Secured Party's option and Borrower's expense, at any time, or from time to time, all acts and things that Secured party deems necessary to protect, preserve, or realize on the Collateral and the Secured Party's security interests therein and to effect the intent of this Agreement, all as fully and effectively as Borrower might do.

(b) Borrower hereby ratifies all that said attorneys shall lawfully do or cause to be done by virtue of this Agreement. All powers, authorizations, and agencies contained in this Agreement are coupled with an interest and are irrevocable until this Agreement is terminated and the security interests created by this Agreement are released.

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Appendix D-9

Patent and Trademark Transfer Statement

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Effective as of _ _[*date*]_ _

This TRANSFER STATEMENT ("Transfer Statement") is presented under the provisions of Section 9-619 of the Uniform Commercial Code, effective in the State of _ _[*state*]_ _ ("UCC"). As required by the UCC, on receipt of this Transfer Statement, the U.S. Patent and Trademark Office shall (i) accept the Transfer Statement, and (ii) promptly amend its records to reflect the transfer described herein.

1. SECURED OBLIGATIONS. _ _[*Name of Borrower*]_ _ ("Borrower 1") and _ _[*name of Borrower*]_ _ ("Borrower 2" and, together with Borrower 1, the "Borrowers") entered into a Credit Agreement, dated as of _ _[*date*]_ _ (as amended, supplemented, or otherwise modified from time to time, the "Credit Agreement"), with the banks and other financial institutions and entities from time to time party thereto (the "Lenders"); _ _[*name*]_ _, as sole lead arranger and sole book manager, and _ _[*name*]_ _, as administrative agent for the Lenders (in such capacity, the "Administrative Agent"), under which the Lenders extended credit and other financial accommodations to or for the direct or indirect benefit of Borrower 1 and Borrower 2. To secure the payment and performance of the obligations of the Borrowers under the Credit Agreement, the Borrowers and the Administrative Agent entered into _ _[*title(s) of security agreement(s)*]_ _ each dated as of even date with the Credit Agreement (collectively, the "Security Agreements"), whereby the Borrowers granted to the Administrative Agent, as agent for the Lenders, a continuing perfected security interest in and lien on all the Borrowers' assets (the "Borrowers' Collateral"), including, among other things, _ _[*describe the particular intellectual property subject to the Security Agreements*]_ _ (the "Transferred Patents and Trademarks").

2. DEFAULT. Borrowers defaulted on their obligations to Lenders with respect to the Credit Agreement and the Security Agreements.

3. EXERCISE OF POST-DEFAULT REMEDIES. The Administrative Agent, as agent for the Lenders, has foreclosed on the Transferred Patents and Trademarks by selling the Transferred Patents and Trademarks, along with other assets of the Borrowers, to _ _[*name of transferee*]_ _ (the "Transferee") at a private foreclosure sale under Section 9-610 of the _ _[*name of state*]_ _ Uniform Commercial Code.

4. TRANSFEREE'S RIGHTS IN TRANSFERRED PATENTS AND TRADEMARKS. As a result of the Administrative Agent's foreclosure sale, and in accordance with the terms of _ _[*title of purchase and sale agreement*]_ _ dated as of _ _[*date*]_ _, the Transferee has acquired all right, title, and interest of the Borrowers in the Transferred Patents and Trademarks, and the underlying invention described therein, and all divisions, renewals, reissues, continuations, and continuations-in-part thereof, and all patents of the United States that have been or may be granted thereon and all foreign counterparts thereof, including _ _[*identify international patents and patent applications*]_ _, together with the right to sue and recover damages for future or past infringements thereof and to fully and entirely stand in the place of the Borrowers in all matters related thereto.

5. NAMES; MAILING ADDRESSES. The names and mailing addresses of the Borrowers, the Administrative Agent, and the Transferee are as follows:

<u>Borrower 1</u>:

_ _[*Name*]_ _
_ _[*Address*]_ _

<u>Borrower 2</u>:

_ _[*Name*]_ _
_ _[*Address*]_ _

Administrative Agent:

_ _[*Name*]_ _
_ _[*Address*]_ _

Transferee:

_ _[*Name*]_ _
_ _[*Address*]_ _

Nothing contained in this document shall act as a waiver of any of the rights of the Lenders or of the Administrative Agent as agent for the Lenders under the Credit Agreement or the Security Agreements, any documents executed in connection therewith, or applicable law, all of which are expressly reserved.

Administrative Agent

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Appendix E

Sample Alternative Dispute Resolution Provisions

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Capitalized terms used herein shall have the same meaning as set forth in the Agreement, unless otherwise defined herein.

Subject to Section _ _[*§number*]_ _ of the Agreement, in the event of any dispute, difference, or question arising between the Parties in connection with the Agreement, the construction thereof, or the rights, duties, or liabilities of either Party, excluding any dispute or controversy for which arbitration is prohibited by any applicable law or treaty, and which dispute is not amicably resolved by the good faith efforts of the Parties under Section _ _[*§number*]_ _ of the Agreement, then, if either Party so requests, the dispute shall be resolved by binding Alternative Dispute Resolution ("ADR") in the manner described below:

(a) If any Party intends to begin ADR to resolve a dispute, that Party shall provide written notice to counsel for the other Party informing the other Party of such intention and the issues to be resolved. Within 10 business days after the receipt of such notice, the other Party may, by written notice to the counsel for the Party initiating ADR, add additional issues to be resolved. From the date of the ADR notice and until such time as any matter has been finally settled by ADR, the running of the time periods in which a Party must cure a breach of this Agreement shall be suspended as to the subject matter of the dispute.

(b) Within 5 business days following the receipt of the original ADR notice ("Notice Date"), a neutral shall be selected by the then chief executive officer of the International Institute for Conflict Prevention and Resolution ("CPR"), 575 Lexington Avenue, 21st floor, New York, New York 10022. The neutral shall be an individual who shall preside in resolution of any disputes between the Parties. The neutral selected shall be a member of the judicial panel of the CPR and shall not be an employee, director, or shareholder of either a Party or of an Affiliate of either Party.

(c) Each Party shall have 10 business days from the date the neutral is selected to object in good faith to the selection of that person. If either Party makes such an objection, the then chief executive officer of the CPR shall, as soon as possible thereafter, select another neutral under the same conditions set forth above. This second selection shall be final.

(d) No later than 90 business days after selection, the neutral shall hold a hearing to resolve each of the issues identified by the Parties.

(i) Each Party shall have the right to be represented by counsel at the hearing.

(ii) The hearing shall be held in the continental United States at such place as agreed on by the Parties or, if they are unable to agree, at a place designated by the neutral.

(e) The ADR proceeding shall be confidential and the neutral shall issue appropriate protective orders to safeguard each Parties' Confidential Information. Except as required by law, no Party shall make (or instruct the neutral to make) any public announcement with respect to the proceedings or the decision of the neutral without the prior written consent of each other Party. The existence of any dispute submitted to ADR, and the award of the neutral, shall be kept in confidence by the Parties and the neutral, except as required in connection with the enforcement of such award or as otherwise required by applicable law.

(f) It is the intention of the Parties that discovery, although permitted as described herein, will be extremely limited except in exceptional circumstances. The neutral shall permit such limited discovery as is necessary for an understanding of any legitimate issue raised in the ADR proceeding, including the production of documents. Each Party shall be permitted but not required to take the deposition of not more than 5 persons, each such

deposition not to exceed 6 hours in length. If the neutral believes that exceptional circumstances exist, and additional discovery is necessary for a full and fair resolution of the issue, the neutral may order such additional discovery as the neutral deems necessary. At the hearing, the Parties may present testimony (either by live witness or deposition) and documentary evidence. The neutral shall have sole discretion with regard to the admissibility of any evidence and all other materials relating to the conduct of the hearing.

(g) Each Party shall be entitled to no more than 4 hours of hearing to present testimony or documentary evidence. The testimony of both Parties shall be presented during the same calendar day. Such time limitation shall include any direct, cross, or rebuttal testimony, but such time limitation shall only be charged against the Party conducting such direct, cross, or rebuttal testimony. It shall be the responsibility of the neutral to determine whether the Parties have had the 4 hours to which they are entitled. If the neutral believes that exceptional circumstances exist, and additional hearing time is necessary for a full and fair resolution of the issue, the neutral may order such additional hearing time as the neutral deems necessary.

(h) At least 15 business days before the date set for the hearing, each Party shall submit to each other Party and the neutral a list of all documents on which such Party intends to rely in any oral or written presentation to the neutral and a list of all witnesses, if any, such Party intends to call at such hearing and a brief summary of each witness's testimony.

(i) At least 5 business days before the hearing, each Party shall submit to the neutral and serve on each other Party a proposed ruling on each issue to be resolved. Such writing shall be limited to presenting the proposed ruling, shall contain no argument or analysis of the facts or issues, and shall be limited to not more than 10 pages.

(j) Not more than 5 business days following the close of hearings, the Parties may each submit post-hearing briefs to the neutral addressing the evidence and issues to be resolved. Such post-hearing briefs shall not be more than 50 pages.

(k) The neutral shall rule on each disputed issue after the hearing as expeditiously as possible, but in no event more than 30 days after the close of the hearings. The neutral shall, in rendering his or her decision, apply the substantive law of the state of _ _[*specify*]_ _, U.S.A., and without giving effect to its principles of conflicts of law, and without giving effect to any rules or laws relating to arbitration. The neutral is not empowered with the remedy of termination of the license(s) granted by this Agreement.

(l) Any judgment on the award rendered by the neutral may be entered in any court having jurisdiction thereof. The decision rendered in any such ADR shall be final and not appealable, except in cases of fraud or bad faith on the part of the neutral or any Party to the ADR proceeding in connection with the conduct of such proceedings, and shall be enforceable in any court of competent jurisdiction.

(m) The neutral shall have the option to assess costs and expenses to the nonprevailing Party; otherwise the Parties shall pay their own costs (including, without limitation, attorney fees) and expenses in connection with such ADR.

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Appendix F

Sample Intellectual Property Infringement Indemnification Provisions

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EXAMPLE 1: SOFTWARE LICENSE

(a) Except as provided in this Section _ _[*§number*]_ _, Licensor shall defend and indemnify Licensee from and against any damages, liabilities, demands, claims, costs, and expenses (including reasonable attorney fees) arising out of any claim that the Software infringes a valid patent or copyright or misappropriates a trade secret of a third party, provided, however, that: (i) Licensee shall have promptly provided Licensor written notice thereof and reasonable cooperation, information, and assistance in connection therewith, and (ii) Licensor shall have sole control and authority with respect to the defense, settlement, or compromise thereof.

(b) If any Software becomes or, in Licensor's opinion, is likely to become the subject of any injunction preventing its use as contemplated by this Agreement, Licensor may, at its option: (i) procure for Licensee the right to continue using such Software, (ii) replace or modify such Software so that it becomes noninfringing without substantially compromising its functionality, or, if (i) and (ii) are not reasonably available to Licensor, then (iii) terminate Licensee's license to the allegedly infringing Software and pay Licensee an amount not to exceed the depreciated value of the Software for which Licensee has paid a license fee, depreciated on a straight-line basis over a _ _[*number, e.g., 3*]_ _-year period.

(c) Licensor shall have no liability or obligation to Licensee under this Section _ _[*§number*]_ _ with respect to any patent, copyright, or trade secret infringement claim based on: (i) use of the Software in an application or environment, or on a platform, or with devices for which the Software was not designed or contemplated; (ii) modifications, alterations, combinations, or enhancements of the Software not created by Licensor; or (iii) any patent, copyright, or trade secret in which Licensee or any Affiliate has an interest. Licensee shall indemnify and hold Licensor harmless from all costs, damages, and expenses (including reasonable attorney fees) arising from any claim described in clauses (i) through (iii) above.

(d) This Section _ _[*§number*]_ _ states the entire liability of Licensor with respect to infringement of patents, copyrights, and trade secrets by the Software or any part thereof or by their operation. Licensee shall immediately inform Licensor as soon as Licensee becomes aware of any threatened or actual liability claim by a third party relating to the Software.

EXAMPLE 2: WEB-BASED SERVICE AGREEMENT

(a) Seller shall defend, indemnify and hold harmless Buyer and its successors and assigns from and against all third party claims, demands, suits, and proceedings and any and all damages, liabilities, costs, and expenses (including reasonable attorney fees and court costs) finally awarded against Buyer as a result of any and all such claims, demands, suits, and proceedings against Buyer arising from (i) infringement by Seller's Web Service or any content on Seller's Web Service (excluding any Buyer Materials) of any third party patent, copyright, trademark, or trade dress, or (ii) misappropriation by Seller of any third party trade secret in connection with any of the foregoing. In the event Seller determines that such an infringement may exist, Seller may, at its option and expense, take such action as its deems appropriate to eliminate such infringement or, if such infringement cannot be avoided in a commercially reasonable manner as determined by Seller, terminate this Agreement. Seller assumes no liability for infringement claims arising from a combination of Seller's Web Service or the content on Seller's Web Service with any products or services not provided by Seller.

(b) Buyer shall defend, indemnify, and hold harmless Seller and its successors and assigns from and against all third party claims, demands, suits, and proceedings and any and all damages, liabilities, costs, and expenses (including reasonable attorney fees and court costs) finally awarded against Seller as a result of any and all such claims, demands, suits, and proceedings against Seller arising from (i) infringement by the Buyer Materials of any third party patent, copyright, trademark, or trade dress, (ii) misappropriation by Buyer of any third party trade secret in connection with any of the foregoing, (iii) any libelous, defamatory, disparaging, pornographic, or obscene materials contained in any of the Buyer Materials provided to Seller under this Agreement, or (iv) any act or failure to act by Buyer in connection with its use of any confidential information received from Seller.

(c) The right of a party (the "indemnified party") to indemnification under this Agreement shall be conditioned on the following: (i) prompt written notice to the party obligated to provide indemnification (the "indemnifying party") of any claim, action, or demand for which indemnity is claimed; (ii) control of the investigation, preparation, defense, and settlement thereof by the indemnifying party; and such reasonable cooperation by the indemnified party, at the indemnifying party's request and expense, in the defense of the claim. The indemnified party shall have the right to participate in the defense of a claim by the indemnifying party with counsel of the indemnified party's choice at the indemnified party's expense. The indemnifying party shall not, without the prior written consent of the indemnified party, which shall not be unreasonably withheld, settle, compromise, or consent to the entry of any judgment that imposes any liability on the indemnified party.

EXAMPLE 3: SUPPLIER AGREEMENT

In the event that any Product sold by Seller to Customer infringes any U.S. patent, trade secret, copyright, or trademark of a third party, Seller shall indemnify Customer as follows:

(a) *Indemnification.* In any litigation by the third party against Customer, Seller shall pay any monetary judgments, including damages, attorney fees, and costs that are awarded by a court of competent jurisdiction to the third party for such infringement claim. Seller shall pay any amount paid to settle such infringement claim or litigation, provided that the settlement is approved in writing by Seller. Seller shall defend Customer in any such litigation against claims of such infringement and shall pay all attorney fees and other costs of such defense. Seller has no obligation to pay for any other damages of Customer or for any loss of profits or business.

(b) *Conditions.* Seller's indemnification obligations under this Paragraph _ _[*number*]_ _ are conditioned on the following: (i) Customer promptly gives written notice to Seller of any claim against Customer alleging such infringement, (ii) Customer allows Seller to control the defense and settlement of such claim and any litigation or arbitration of such claim or infringement, and (iii) Customer fully cooperates with Seller in connection with such defense, settlement, litigation, and arbitration. Seller shall have no obligation or liability if the infringement or claim arises from or is based on: (1) any change, modification, or addition to the Product after it is delivered by Seller to Customer, or (2) the use or existence of the Product in combination with anything not sold or provided by Seller to Customer, or (3) the use of the Product other than as described in the documentation that accompanies the Product, or (4) specifications, requirements, trademarks, or trade dress requested, specified, or required by Customer for the Product, or (5) any patent that issues after the date the Product is first delivered to Customer, or (6) the law of any foreign country or jurisdiction. Customer shall mitigate damages in the event of infringement and cooperate with the reasonable requests of Seller for mitigation. If requested by Seller, Customer shall cease use of any infringing Product. Seller shall have no obligation or liability with respect to claims brought by third parties who are affiliated with Customer.

(c) *Injunction or Cessation of Use.* If Customer is enjoined from continued use of any infringing Product or if Customer ceases use of any Product at the request of Customer under subparagraph (b) above, then Customer shall (at its expense and option): (i) obtain the right for Customer to continue to use the Product in accordance with the Licensee documentation that accompanied the Product, the applicable software license agreement, and this Agreement, (ii) modify the infringing Product to eliminate the infringement, (iii) provide a substitute noninfringing Product to Customer under this Agreement, or (iv) offer to refund to Customer the amount paid under this Agreement for the infringing Product (such refund to be a portion of the purchase price paid to Customer for the Product based on when the Product was delivered to Customer and prorated over a 5-year period, *e.g.*, if delivery occurred 2 years before to the refund, then the refund would be 60 percent of the purchase price). If a Product within the scope of this indemnification has not yet been shipped to Customer, then Seller may cancel the order of such Product and neither Party shall have any obligation or liability to the other with respect to the cancellation or such unshipped Product.

(d) *Clarifications.* In the event that Seller and the third party agree to arbitration, then subparagraphs (a) through (c) shall apply to such arbitration in the same manner as to litigation. Any reference in this Paragraph _ _[*number*]_ _ to "infringement" shall mean, when used in the context of a trade secret, the "misappropriation" of a trade secret.

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Internet Resources for California Businesses

A. Government Sites—Federal

Americans with Disabilities Act	http://www.usdoj.gov/crt/ada Information and technical assistance on the ADA by the U.S. Department of Justice.
Bureau of Industry and Security (BIS), U.S. Department of Commerce	http://www.bis.doc.gov/about/index.htm Federal agency that administers the U.S. export control and treaty compliance system, including the Export Administration Regulations (EAR).
BusinessLaw.gov	http://www.business.gov/ Home page, operated by the U.S. Small Business Administration, with links to legal and regulatory information, and plain English guides for starting a business, handling finances, managing employees, and other topics.
CIA, The World Factbook	https://www.cia.gov/cia/publications/factbook/index.html U.S. government profiles of countries and territories around the world.
Equal Employment Opportunity Commission (EEOC)	http://www.eeoc.gov/ EEOC site with basic introduction to employers' rights and responsibilities under the federal equal employment opportunity laws.
Federal agencies (through Library of Congress site)	http://www.loc.gov/rr/news/fedgov.html A Library of Congress resource page with links to most federal agencies.
Federal Citizen Information Center (FCIC)	http://www.pueblo.gsa.gov/ Part of the U.S. General Service Administration, the FCIC's Small Business Links offer information for persons planning or owning small businesses, including information on procurement, taxes, woman- and minority-owned businesses, human resources, and financial and legal issues.
Federal Deposit Insurance Corporation (FDIC)	http://www.fdic.gov/ Home page with links to statistical data, pertinent regulations, and FAQs.
Federal Reserve Bank of San Francisco	http://www.frbsf.org/ Home page. The current FRBSF discount rate, used to determine the usury ceiling in California, is posted at http://www.frbsf.org/banking/data/discount/index.html.
Federal Trade Commission	http://www.ftc.gov/ftc/business.shtm Home page for businesses, with links to business publications, advertising guidance, fair packaging and labeling, antitrust law guide, and other topics. Information concerning the Hart-Scott-Rodino pre-merger notification requirements is at http://www.ftc.gov/bc/hsr/introguides/introguides.htm.
FirstGov.gov	http://www.firstgov.gov/Business/Business_Gateway.shtml The official web portal of the U.S. government, with links to information on contracting with the U.S. government, export licenses, business financial assistance, and many other topics.
Internal Revenue Service	http://www.irs.gov/ Home page; access to downloadable IRS forms and publications.
Occupational Safety and Health Administration	http://www.osha.gov/ Home page.

(OSHA)	
Office of Federal Contract Compliance Programs (OFCCP)	http://www.dol.gov/esa/ofccp/index.htm Home page with statutory, regulatory, and compliance information regarding nondiscrimination requirements for federal contractors.
Office of the Comptroller of the Currency (OCC)	http://www.occ.treas.gov/ Home page with links to reports and other resources for banking industry professionals as well as public information about the national banking system.
Office of the U.S. Trade Representative	http://www.ustr.gov/index.html Home page.
Securities and Exchange Commission (SEC)	http://www.sec.gov/ Home page with links to information for small businesses; online access to proposed and final rules, SEC releases, policy statements, and other commission notices and information; searchable database of all electronic company filings since 1994.
SEC Edgar	http://www.sec.gov/edgar.shtml SEC Edgar main page, with access to electronic filings and forms.
Small Business Administration	http://www.sba.gov/ Home page with extensive links to federal and other resources for small businesses.
Social Security Administration	http://www.ssa.gov/ Home page. SSA forms are available online at http://www.ssa.gov/online/forms.html.
THOMAS	http://thomas.loc.gov/home/thomas.html Website of the Library of Congress providing federal legislative information.
U.S. Citizenship and Immigration Services	http://www.uscis.gov/portal/site/uscis Home page with links to immigration laws and forms.
U.S. Copyright Office	http://www.copyright.gov/ Home page with links to copyright registration and other information.
U.S. Department of Commerce	http://www.commerce.gov/ Home page.
U.S. Department of Justice, Antitrust Division	http://www.usdoj.gov/atr/public/guidelines/guidelin.htm Link to Antitrust Division Guidelines and Policy Statements.
U.S. Department of Labor	http://www.dol.gov/ Home page with links to statutory and regulatory information, labor statistics, small business regulatory compliance assistance, and other information.
U.S. Department of Labor, Dictionary of Occupational Titles (DOT)	http://www.oalj.dol.gov/libdot.htm Dictionary of job titles and standardized job descriptions; useful for job placement, occupational research, career guidance, labor-market information, curriculum development, and long-range job planning. Last updated in 1991, the DOT has now been replaced by O*NET Online, http://online.onetcenter.org/.
U.S. Department of State	http://www.state.gov/ Home page with links to international commercial laws and guides.
U.S. Environmental Protection Agency	http://www.epa.gov/ Home page.

U.S. Government Printing Office	http://www.gpo.gov/ Home page with links to products and services, including online searchable copies of the United States Code and the Code of Federal Regulations.
U.S. International Trade Commission	http://www.usitc.gov/ Home page with rules, regulations, reports, and other information, including an extensive list of links to international trade resources.
U.S. Patent and Trademark Office	http://www.uspto.gov/ Home page with downloadable forms and information on patent applications and trademark registrations.

B. International Sites

Private International Law Database: Trade/Business Transactions Law, U.S. Department of State	http://www.state.gov/www/global/legal_affairs/transaction_law.html Access to treaties in force for the United States, other international instruments, and information on current negotiations and projects concerning private international law. Updated through January 1, 2001. For treaty actions since President Bush took office, see http://www.state.gov/s/l/treaty/c3428.htm.
CURIA	http://curia.europa.eu/en/transitpage.htm Home page of the courts of the European Communities, with texts governing procedures and searchable case law.
Electronic Embassy Website	http://www.embassy.org/ Information on all foreign embassies in Washington, D.C.
EUR-Lex	http://eur-lex.europa.eu/en/index.htm Website providing direct free access to European Union law. Among other things, it includes the Official Journal of the European Union, treaties, legislation, case law and legislative proposals.
European Franchise Federation (EFF)	http://www.eff-franchise.com/ Non-profit international organization that promotes the interests and development of franchising in Europe.
Hague Conference on Private International Law (HCCH)	http://hcch.e-vision.nl/index_en.php?act=text.display&tid=1 Home page.
International Trademark Association (INTA)	http://www.inta.org INTA is an international nonprofit membership association dedicated to the support and advancement of trademarks and related intellectual property.
North American Free Trade Agreement (NAFTA) Secretariat	http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx Home page with link to text of NAFTA.
United Nations Commission on International Trade Law (UNCITRAL)	http://www.uncitral.org/ Home page with links to UNICITRAL texts, including conventions, model laws, guides to enactment, legislative guides, legislative recommendations, and model contract rules. In particular, this website includes the text of the United Nations Convention on Contracts for the International Sale of Goods (CISG).
CISG Database at Pace University School of Law, Pace Law Library, Institute of	http://cisgw3.law.pace.edu/ Site dedicated to U.N. Convention on Contracts for the International Sale of Goods (CISG), with annotated text of CISG, CISG in different languages, cases organized by countries, and related CISG material.

International Commercial Law	
International Institute for the Unification of Private Law (UNIDROIT)	http://www.unidroit.org/english/home.htm Home page.
Canadian System for Electronic Document Analysis and Retrieval (SEDAR)	http://www.sedar.com/ Home page of the Canadian equivalent to the SEC's EDGAR. Provides access to corporate filings of Canadian companies with Canada's securities regulatory authorities.
World Intellectual Property Organization (WIPO)	http://www.wipo.int/portal/index.html.en A specialized agency of the United Nations, dedicated to developing a balanced and accessible international intellectual property system.
World Trade Organization (WTO)	http://www.wto.org/ Global international organization dealing with the rules of trade between nations.

C. Government Sites—California

California Department of Corporations, Securities Regulation Division	http://www.corp.ca.gov/SRD/Default.asp Access to forms, departmental publications, Commissioner's releases, opinions and notices, franchising information, and other topics.
California Department of Fair Employment and Housing	http://www.dfeh.ca.gov/ Home page.
California Department of Insurance, Workers' Compensation Information	http://www.dir.ca.gov/workers'_comp.html Access to information on workers' compensation insurance.
California Division of Occupational Safety and Health (DOSH)	http://www.dir.ca.gov/dosh Access to information concerning the Cal-OSHA program.
California Employment Development Department (EDD)	http://www.edd.ca.gov Home page; information concerning job placement and referrals, unemployment insurance, disability insurance, employment and training, labor-market information, payroll taxes, and other topics.
California Franchise Tax Board (FTB)	http://www.ftb.ca.gov/ Home page with links to downloadable state tax forms and publications.
California Law Revision Commission	http://www.clrc.ca.gov/ Home page.
Official California Legislative Information	http://www.leginfo.ca.gov/index.html Full text of bills, resolutions, and constitutional amendments, as well as their status, history, votes, analyses, and veto messages.
California Legislative Resource	http://calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10137&id=10452 Webpage maintained by the State Bar of California with many helpful links regarding California's legislative process, pending bills, legislative calendar, committees, and other topics.

State Bar of California Bill Tracking Service	http://www.calbar.ca.gov/calbar/legislation/State%20Bar%20Bill%20Tracking-Sections.html Centralized legislative monitoring and tracking service listing bills of potential interest to members of the State Bar's sections and their committees.
California Business Permits and Licensing Information	http://www.calgold.ca.gov/ To locate appropriate permitting information for California businesses, the CalGOLD database provides links and contact information that direct users to agencies that administer and issue business permits, licenses, and registration requirements from all levels of government.
California State Office of Privacy Protection	http://www.privacy.ca.gov/ State agency dedicated to promoting and protecting the privacy rights of consumers.
California state agencies	http://www.ca.gov/state/portal/myca_homepage.jsp State of California site with links to California agencies, departments, and commissions.
California State Association of Counties	http://www.csac.counties.org/ Home page with links to all California counties.
California State Board of Equalization	http://www.boe.ca.gov/ Home page with access to information about sales and use taxes, sellers' permits, forms, and publications.
California Secretary of State: California Business Portal:	http://www.ss.ca.gov/business/business.htm Home page.
Forms:	http://www.ss.ca.gov/business/bpd_forms.htm Directory of forms and samples for different business filings, including UCC forms; some in fill-in format.
Business Filings:	
Corporations	http://www.ss.ca.gov/business/corp/corporate.htm Corporations main page with links to filing tips to meet statutory minimum requirements, name availability, FAQs, and more.
Limited Liability Companies (LLCs)	http://www.ss.ca.gov/business/llc/llc.htm LLC main page with links to forms and fees, name availability, FAQs, and more.
Limited Partnerships	http://www.ss.ca.gov/business/lp/lp.htm Limited partnerships main page with links to forms and fees, name availability, FAQs, and more.
General Partnerships	http://www.ss.ca.gov/business/gp/gp.htm General partnerships main page with links to forms and fees, name availability, FAQs, and more.
Limited Liability Partnerships	http://www.ss.ca.gov/business/llp/llp.htm Limited liability partnership main page with links to forms and fees, name availability, FAQs, and more.
Trademarks and Service Marks	http://www.ss.ca.gov/business/ts/ts.htm Trademarks and service marks main page with links to forms and fees, name availability, FAQs, private service companies, and more.
Miscellaneous Filings	http://www.ss.ca.gov/business/other/bp_other.htm Links to filing requirements for unincorporated common interest development

	associations, unincorporated associations, unincorporated nonprofit associations, foreign lending institutions, and foreign partnerships.
California Business Search	http://kepler.ss.ca.gov/list.html Fill-in boxes to check records online for corporations, limited partnerships, and limited liability companies.
Starting a Business	http://www.ss.ca.gov/business/resources.htm A step-by-step guide for starting a business in California; available in English or Spanish.
e-file Statement of Information	https://businessfilings.ss.ca.gov/ Fill-in boxes to file a Statement of Information for a corporation online.
Notary Public	http://www.ss.ca.gov/business/notary/notary.htm Notary public main page, with links to topics such as obtaining a notary public commission, handbook, authentications, apostille or certification, forms, and fees.
Uniform Commercial Code	http://www.ss.ca.gov/business/ucc/ucc.htm UCC main page with links to financing statement forms, amendment forms, requests for information, revised Article 9 (as of July 1, 2001), and FAQs.
International Business Relations Program	http://www.ss.ca.gov/business/ibrp/ibrp.htm Main page in English or Spanish with international resources and business tips; intended to assist foreign corporations with various filing procedures.
Business Program Division, Legislation	http://www.ss.ca.gov/business/bpd_newleg.htm Summaries and links to new state laws affecting businesses.

D. Private Agency Sites

ABA Section of Business Law	http://www.abanet.org/buslaw/home.html Home page with links to publications and other resources for business lawyers.
Active Capital	http://activecapital.org/ Site dedicated to helping individual accredited investors, SBICs, and institutional venture capitalists find small, growing companies through a secure Internet database, and providing ongoing training and research for entrepreneurs and small investors.
AllBusiness	http://www.allbusiness.com Small business portal, with links to forms, directories, and resources on many topics.
American Arbitration Association	http://www.adr.org/ Home page with links to rules and procedures.
Annual Reports.com	http://www.annualreports.com/ Free service offering links to annual reports of public companies.
BenefitsLink	http://www.benefitslink.com Compliance information and tools for employee benefit plan sponsors, service-providers, and participants.
Better Business Bureau	http://www.bbb.org/ Home page.
The Biz-Tech Network by Brint Institute, LLC	http://www.brint.com/ Portal with a meta-index of business, management, and information technology topics; it also provides search capabilities and full text articles on

	related issues.
Business.com	http://www.business.com/ Business search engine and directory intended to help users find companies, products, services, and other business-related information; some features are fee-based.
Business Law Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?sCategoryPath=/Home/Attorney%20Resources/Sections/Business%20Law Home page with links to standing committees, programs, and publications.
Business Week Online	http://www.businessweek.com/ Articles, links, and opportunity to subscribe to free newsletter.
CNN Money	http://money.cnn.com/ General business news website offered by CNN and Fortune, Money and Business 2.0 magazines.
Corporate Finance Sourcebook	http://www.financesourcebook.com/ Link for ordering popular guidebook published by National Register Publishing. The guidebook features over 1500 top investment sources and 1700 service firms for business entrepreneurs.
Corporate Information	http://www.corporateinformation.com/ Subscription-based website offering research reports on public, private, domestic, and foreign corporations.
The Corporate Library	http://www.thecorporatelibrary.com/ The Corporate Library is an independent research firm providing corporate governance data, analysis, and risk assessment tools.
Creative Commons	http://creativecommons.org A nonprofit organization founded by Prof. Lawrence Lessig of Stanford University that provides special copyright license forms and other free tools to enable authors, scientists, artists, and educators to share intellectual property.
DeVry University Business Administration Portal	http://www.academicinfo.net/busmeta.html Portal with annotated links to a variety of business-related topics.
Dun & Bradstreet	http://www.dnb.com/ Home page of Dun & Bradstreet. Subscribers can request reports and run online queries in proprietary databases.
Edgar Online, Inc.	http://www.edgar-online.com/ Edgar Online, Inc. is a private company, not affiliated with the SEC, specializing in the extraction, packaging, and distribution of public company information contained in SEC filings.
Enterpreneur.com	http://www.entrepreneur.com/mag Free access to Entrepreneur magazine articles back to 1997.
Financial Accounting Standards Board (FASB)	http://www.fasb.org/ Access to FASB Statements of Financial Accounting Standards and other resources.
Findlaw Business Center	http://smallbusiness.findlaw.com/ Portal with links to articles and guides on starting a business, taxes and accounting, small business legal concerns, and more. Part of West Group.
FindNews.org	http://www.findnews.org/business-news/small-business.html

	Online news directory with links to other news-oriented sites and small business portals.
Garage Technology Ventures	http://www.garage.com/ Venture capital fund for emerging technology companies.
GNU	http://www.gnu.org/ Organization promulgating the development and use of free software and the use of open-source software licenses.
Google Small Business Directory	http://directory.google.com/Top/Business/Small_Business/ A directory of small business resources.
Hieros Gamos Small Business Center	http://www.hg.org/sbcenter.html Portal with links to topics such as starting a business, choosing a legal structure, and financing.
Hoover's Online	http://www.hoovers.com/ Subscription-based site with industry snapshots, company profiles, earnings, and other information.
Intellectual Property Section of the State Bar of California	http://www.calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?cid=10707 Home page with links to standing committees, programs, and publications.
International Franchise Association (IFA)	http://www.franchise.org/ Trade association promoting responsible franchise development worldwide.
Internet Corporation for Assigned Names and Numbers (ICANN)	http://www.icann.org/ Private agency responsible for global coordination of the Internet's system of unique identifiers, including domain names (such as .com, .org, and country codes such as .fr), as well as addresses used in a variety of Internet protocols.
IP Mall	http://ipmall.info/ Website sponsored by Franklin Pierce Law Center, with links to intellectual property resources around the world (including patents, copyrights, trademarks, trade secrets, licensing, and technology transfers).
JAMS	http://www.jamsadr.com/index.asp Home page with information about JAMS mediation and arbitration services and a search engine to assist in locating qualified mediators and arbitrators. The website also offers a downloadable guide to dispute resolution clauses in commercial contracts.
Jeffren Publishing Co.	http://www.jefren.com Subscription service offering proxy statement forms and strategies.
MarketResearch.com	http://www.marketresearch.com/ Free database of market research reports representing all market and industry sectors.
MegaLaw.com Small Business Portal	http://www.megalaw.com/top/smbusiness.php Portal with links to federal agencies and other websites related to small businesses.
NASDAQ and American Stock Exchanges (mirrored site)	http://www.nasdaq.com/ *and* http://www.amex.com/ Comprehensive current information on market performance and investments.
National Association of Attorneys General	http://www.naag.org/

	Association of the attorneys general of all 50 states, with contact information and links to enforcement initiatives.
National Association of Secretaries of State, Business Registration and Filing Services	http://www.nass.org Access to most state business and corporations divisions from a single webpage.
National Association of Seed and Venture Funds	http://www.nasvf.org/ Network of private, public, and nonprofit organizations investing and facilitating investment in entrepreneurs.
National Business Association	http://www.nationalbusiness.org/ Nonprofit association's site for the self-employed and small business community.
National Venture Capital Association (NVCA)	http://www.nvca.org/ Home page with links to members and other resources.
New York Stock Exchange	http://www.nyse.com/ Comprehensive, current information on market performance and investments.
News Cuts	http://www.newscuts.com/Small.Business.shtml Free and fee-based small business news service.
Open Directory Project - Small Business	http://www.dmoz.org/Business/Small_Business/ Free site with links to topics such as business plans, finance, home offices, and start-ups; edited by volunteers.
Public Register's Annual Report Service	http://www.annualreportservice.com/ Free access to annual reports of over 2200 companies. Site also has links to the SEC's Edgar database for filings.
Reuters	http://today.reuters.com/news/newsChannel.aspx?type=businessNews Database providing research reports on companies and industries.
Safeselling.org	http://www.safeselling.org/ ABA-sponsored resource for business people launching e-commerce enterprises and for businesses venturing into online sales.
The Small Business Portal	http://www.thesmallbusinessportal.com/ Links to topics such as starting a business, franchise advice, financing, and home-based businesses.
Standard & Poor's	http://www.standardandpoors.com/ Home page with search engine for public company credit ratings and other features.
Tripod by Lycos	http://www.tripod.lycos.com/smallbiz/index.html Portal with tips on starting an online business, yellow pages, and some free and some fee-based services.
U.S. GAAP Website	http://cpaclass.com/gaap/ Comprehensive source of information on generally accepted accounting principles in the U.S.
Wall Street Journal Online Edition	http://online.wsj.com General business and financial news.
Washburn University School of Law Small Business	http://www.washlaw.edu/subject/small.business.html Portal with links to a forms library and business and economic data.

Portal	
Yahoo! Finance	http://biz.yahoo.com/i/ Free company profiles and stock charts for over 9000 public companies.
Yahoo! Small Business	http://smallbusiness.yahoo.com/ Portal with links to topics such as creating a website, promoting a business, and selling online.

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