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TECH LAW L E T T E R



INTELLECTUAL PROPERTY RIGHTS UNDER U.S. GOVERNMENT CONTRACTS

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Most businesspeople understand that they should consider intellectual property ("IP") rights when entering into contracts with other businesses, but some may not know about the special rules that apply to contracts with the U.S. government. First of all, businesspeople should have a basic understanding of the four types of IP:

- Patents (inventions, business methods, etc.);
- Copyrights (software, documents, etc.);
- Trade secrets (confidential business information); and
- Trademarks (indications of origin).

The two types of IP that are most relevant to government contracts are copyrights (primarily because of software and associated documentation) and patents (primarily because of electrical and mechanical devices).

IP can be licensed or assigned. A "license" means the right to use the IP (and perhaps to copy, modify, and do certain other things to it as well). That right can be limited or unlimited, exclusive or nonexclusive, perpetual or for a finite duration, etc. "Assignment" means a transfer of the ownership of the IP — that is, a transfer of *all* IP rights.

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Register Now for the June 1 IP Seminar

Our next IP Seminar will be held on June 1 at the Norfolk Airport Hilton from 8:00 a.m. until 10:00 a.m. Register now at www.willcoxandsavage.com/nep/seminars.php or call 757-628-5635.

IS YOUR SECURED LOAN REALLY "SECURE"? PERFECTING SECURITY INTERESTS IN IP

Henry J. Huelsberg, III and Kevin A. White



Intellectual property ("IP"), which includes copyrights, trademarks, and patents, is an increasingly valuable component of many businesses today. If you lend money to businesses with IP assets, it is critical that you understand the value of IP as collateral and take all necessary steps to protect your loans by securing that collateral.



The Mechanics of Perfection

A lender generally protects its loan by taking a "security interest" in the collateral, and then "perfecting" that security interest. As a result, if the borrower defaults on the loan (or, worse, goes into bankruptcy), the security interest places the lender at the front of the line of creditors laying claim to the collateral.

In general, a lender can perfect its security interest by filing a financing statement, or "UCC-1," under Article 9 of the Uniform Commercial Code, which is state law. However, because ownership of copyrights, trademarks, and patents is generally reflected by registering the IP under federal law, a lender must look to federal requirements to determine how to perfect security interests in the various forms of IP.

Copyrights

To perfect a security interest in a copyright that has been registered with the U.S. Copyright Office, the lender must file the appropriate documents with that Office. Security interests in unregistered copyrights, on the other hand, can be perfected only by a state UCC-1 filing, although, as a practical matter, a lender should require all of the borrower's important copyrights to be federally registered for maximum protection.

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The basic rule is that a company that creates IP owns it unless and until it assigns the IP to someone else. Owning a copy of the IP is not the same thing as owning the IP itself. So giving a deliverable to the government does not mean that the government owns the IP embodied in that deliverable.

The Federal Acquisition Regulations ("FAR") control contracts with the U.S. government. The FAR makes up Title 48 of the U.S. Code of Federal Regulations. The Defense Federal Acquisition Regulations Supplement ("DFARS") controls contracts with the Department of Defense and the departments and agencies under it.

There are two key DFARS sections with respect to IP in which the government claims some rights:

- DFARS Section 252.227-7014, "Rights in noncommercial computer software and noncommercial computer software documentation"; and
- DFARS Section 252.227-7013, "Rights in technical data Noncommercial items."

The difference between the two sections is that "technical data" is defined more generally than "software" and means recorded information of a scientific or technical nature, regardless of its form or characteristics.

The government usually obtains "unlimited rights" in acquired software/technical data. Under certain circumstances the government may be willing to accept "government-purpose rights." Under other circumstances the government may be willing to accept "limited rights" in technical data or "restricted rights" in software.

"Unlimited rights" mean the rights to use, modify, reproduce, release, perform, display, or disclose software/technical data in whole or in part in any manner and for any purpose whatsoever and to authorize others to do so. Although technically license rights, such rights are so broad that they are tantamount to ownership rights.

A contractor's grant to the government of unlimited rights in a deliverable precludes the contractor from making any further sales of that particular deliverable to the government. Moreover, the government may freely disclose the deliverable to the contractor's competitors. As a practical matter, such a grant limits the contractor's ability to commercialize the deliverable, at least in such a way as to dominate the market from the outset.

"Government purpose" means any activity in which the government is a party, including cooperative agreements with international or multi-national defense organizations or sales or transfers by government to foreign governments or international organizations. Such purposes include competitive procurement. Such purposes do not include the rights to use, modify, reproduce, release, perform, display, or disclose software/technical data for commercial purposes or to authorize others to do so.

"Limited rights" and "restricted rights" apply only to non-commercial software/technical data, not to commercial, off-the-shelf ("COTS") items. Such rights are similar to the rights that a company would acquire if it obtained software from a developer pursuant to a negotiated, two-party software license. Typical restrictions on software include limitations on the number of authorized "seats" (i.e., simultaneous users), on making more than minimum number of copies required for archiving, backup, etc., and on modifying software except as required for maintenance purposes.

Willcox & Savage IP Group Wins Reversal before the Trademark Trial and Appeal Board

Willcox & Savage recently won a major victory before the Trademark Trial and Appeal Board of the U.S. Patent and Trademark Office ("PTO") on behalf of Volvo Penta of the Americas. Kevin Grierson, a member of the firm's IP Group, proved that Volvo Penta's OCEAN SERIES mark is not confusingly similar to other "OCEAN" marks and convinced the Board to reverse a contrary finding by the PTO Examining Attorney who handled Volvo Penta's trademark application. The Board seldom reverses the Examining Attorneys; in approximately 80% of cases appealed by applicants the Examining Attorneys' findings are upheld.

The government generally obtains unlimited rights in software/technical data developed solely at government expense. The government generally obtains government-purpose rights (usually for up to five years, when they then become unlimited) in software/technical data developed partly at government expense. The government generally obtains limited/restricted rights in noncommercial software/technical data developed solely at private expense.

Key terms in analyzing what rights the government gets are “developed,” “government expense,” and “private expense.” The FAR does not contain definitions of either “developed” or “private expense.” The DFARS does define all three terms, but the definitions are rather complex.

“Developed” means that an item, component, or process exists and is workable. To be considered “developed”:

- An item, component, or process need not be at stage where it could be offered for sale or sold on commercial market; and
- The item, component, or process need not be reduced to practice within meaning of U.S. patent law.

“Government expense” is defined negatively — in other words, as what it is not rather than what it is:

- Developed exclusively at government expense: development was not accomplished exclusively or partially at private expense;
- Developed with mixed funding: development was accomplished (1) partially with costs charged to indirect cost pools and/or costs not allocated to a government contract, and (2) partially with costs charged directly to a government contract; and
- Developed exclusively at private expense: development was accomplished entirely with costs charged to indirect cost pools, costs not allocated to a government contract, or any combination thereof.

The question of whether a contractor developed software/technical data at government or private expense depends on how the contractor funded such development and accounted for that funding. Contractors should consult their public accounting firms to obtain advice in this area from an accountant’s perspective.

There are certain strategic issues that contractors must consider when agreeing to deliver IP to the government. For example:

- The government may insist on obtaining unlimited rights in many cases, leaving contractors no choice about what IP rights to grant if they wish to bid on those contracts; and
- Some deliverables may be so highly specialized and so closely related to unique government functions that there are few or no potential commercial applications for the deliverables.

The key point is that before entering into a contract grant-

ing the government unlimited rights in IP, contractors should consider whether it might be possible to grant narrower rights, *i.e.*, government-purpose rights or perhaps even restricted rights.

Under the following types of contracting scenarios the government may have rights other than unlimited, government-purpose, or limited/restricted rights:

- Specifically Negotiated License Rights (similar to vendor customer license for custom software);
- Small Business Innovation and Research Program (“SBIR”);
- “Other Transactions” (currently available only within the Departments of Defense, Homeland Security, and Transportation);
- Cooperative Agreements; and
- Cooperative Research and Development Agreements (“CRADAs,” which technically are not procurement agreements and therefore are exempt from the FAR and DFARS).

**Next Hampton Roads International Trademark Association (“INTA”) Roundtable on June 14
Topic: Trademark Selection and Registration**

On June 14 the firm will host the next INTA Roundtable in the Hampton Roads area at Norfolk’s Harbor Club. The most recent INTA Roundtable, held in February, focused on brand protection and branding guidelines. The world’s largest trademark organization, INTA consists of 4,500 trademark owners and professional from over 180 countries. To learn more about the Roundtable series, visit the Association’s web site at www.inta.org.

The FAR and DFARS require contractors to advise the government before entering into contract for software/technical data that will be delivered with less than unlimited rights. The regulations require any such deliverables to be marked with appropriate restrictive legend(s) (including but would not be limited to contractor’s copyright notice). Deliverables not so marked are presumed to have been delivered with unlimited rights. If the lack of restrictive marking was inadvertent, the contractor has six months to correct deficiency, but the contractor must agree to relieve government of any liability for initial unrestricted disclosure. ■

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Even with registered copyrights the lender should also make a state UCC-1 filing to broaden the scope of its security interest. For instance, filing with the U.S. Copyright Office can perfect a security interest only in those parts of works-in-progress (e.g., software programs and film projects) that have already been registered with that Office; a state UCC-1 filing is necessary to cover any further modifications and improvements. In addition, a federal filing does not cover royalties earned from copyrights.

Trademarks

To perfect a security interest in a trademark (including common-law trademarks and both state and federal trademark registrations), the lender must file a UCC-1 in the state where the trademark's owner is located (for business entities, this is normally the state of incorporation or organization). Filing with the U.S. Patent and Trademark Office ("PTO") will not alone perfect a security interest, but the lender should still file with that Office to ensure that subsequent purchasers cannot argue that they did not have notice of the interest and acquired the collateral free of the lien. Also, any security interest in a trademark should include an interest in all "goodwill" related to the trademark to ensure that the lender protects its rights in all aspects of the mark.

Patents

Courts have recently held that security interests in patents and patent applications should be filed at the state level, and that federal filing with the PTO is not enough for perfection. However, even though a state UCC filing is sufficient to perfect a security interest in patents, the lender, as with trademarks, should still file with the PTO to ensure that subsequent purchasers cannot argue that they did not have notice of the interest and acquired the collateral free of the lien.

Domain Names

Internet domain names are increasingly important to many businesses. However, they are still not universally viewed as IP, and in some jurisdictions it may be impossible to perfect a security interest in a domain name. A recent decision by the Supreme Court of Virginia held that a domain name does not amount to a property interest but rather to a contractual right to domain name services. (Interestingly, a Federal Court of Appeals in California recently came to the opposite conclusion.)

Thus, because of the uncertainty in this area, a lender

may want to make a state UCC-1 filing where the borrower's business is located and also in the state where the host server is located. If the domain name is particularly valuable, a lender may also want to have the debtor transfer the domain name into escrow along with a power of attorney in favor of the lender so that the lender can control the domain name in the event of the borrower's default.

Conclusion

The most effective way to perfect security interests in most types of IP is to make both state and federal filings. That approach ensures that the security interest will be perfected even if the law changes or a court decides to interpret the law differently. Also, any potential lender or investor in a company with IP should, in its due diligence, conduct a UCC lien search and also check the records of the PTO and/or the U.S. Copyright Office to determine whether there are other parties with superior rights in the IP. ■

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CONTRIBUTING A PATENT TO AN LLC PRESERVES INCOME TAX BENEFIT

Christopher D. Scott



The Internal Revenue Service recently ruled that contributing a patent to a limited liability company will not prevent the patent-holder from recognizing capital gain instead of ordinary income when the patent is sold by the company to a third party. This ruling — unsurprising but nevertheless welcome — discloses the IRS's likely internal audit position regarding the income tax consequences flowing from contribution of a patent to a partnership or limited liability company.

By way of background, the federal government generally taxes long-term capital gains at a 15% rate and taxes ordinary income at up to a 35% marginal rate. The determination of whether a sale of a patent generates ordinary income or capital gain typically turns on whether the patent is a passive investment asset or the product of a business activity and on the length of time the holder owned the patent.

These general rules would cause most inventors and speculators in new technology to recognize ordinary income from the sale of a patent. However, in limited circumstances Internal Revenue Code ("IRC") Section 1235 grants long-term capital gain treatment to income that would otherwise be taxed at ordinary rates if the holder is an "individual" who created the intellectual property underlying the patent or who purchased the patent from the creator prior to the patent being put to commercial use. A strict interpretation of the "individual" requirement in this statute would cause a patent sale made by a partnership to be outside the statute's protections even if the partnership is owned by individuals who would otherwise be entitled to the benefits of IRC Section 1235.

Fortunately, Treasury Regulations Section 1.1235-2(d)(2) provides that each individual partner may qualify as a holder of his or her share of a patent that is owned by a partnership. As mentioned above, in the absence of IRC Section 1235 most patent sales by a creator or a speculator would be taxed at ordinary rates. Consequently, it is quite important to preserve the protections of this statute.

In addition, neither the federal government nor Virginia imposes an income tax directly on a partnership or a limited liability company taxed as a partnership. Instead, the entity's income is taxed as if it is an aggregation of

its owners, and each owner is taxed on a proportionate share of the entity's taxable income. This aggregation concept also applies to contributions of assets to a partnership or limited liability company so that no taxable income is generated when an owner contributes assets to the entity, and the entity will take a basis in a contributed asset equal to the contributing owner's basis in the property.

The facts underlying the IRS's three favorable rulings are as follows: (1) three individuals ("Holders") created intellectual property through their personal efforts and obtained a patent protecting their ideas; (2) the Holders created a limited liability company that is taxed as a partnership, and each Holder took back a one-third interest in the company; (3) the Holders contributed the patent to the limited liability company; and (4) the limited liability company intends to sell the patent to an unrelated third party.

In this situation the Holders and the limited liability company were clearly entitled not to recognize taxable income upon contribution of the patent to the limited liability company. However, it was unclear whether income generated by a sale of the patent from the limited liability company to an unrelated third party would be entitled to the protections of IRC Section 1235.

The IRS ruled that the limited liability company's gain from the sale of the patent would pass through to each of its members, and that each member would be entitled to report gain from the sale as long-term capital gain pursuant to IRC Section 1235. These rulings give significant comfort to anyone who is contemplating the contribution of a patent to a partnership or limited liability company. Also, the rulings underscore the importance for IP owners of taking tax consequences into account when assigning and licensing their IP assets.

February Seminar on Government Contracting

In February we were pleased to host our latest IP Seminar, which focused on IP issues in the context of government contracts. A special thanks to our panelists from government and private industry: Jack Ezzell, Jr., of Zel Technologies, LLC; Michael Kimener of Booz Allen Hamilton; Jerry Robertson, ODU's Director of Technology Applications; Zohir Handy of ODU's Office of Research; and Damien Walsh of U.S. Joint Forces Command.

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