IP Issues in Contracts: Getting Beyond the Boilerplate

Presentation to 2010 Midwest Intellectual Property Institute

Stacy A. Schultz
Of Counsel
Gibson, Dunn & Crutcher LLP
September 23, 2010

GIBSON DUNN

Contents

- Introduction
- Statements of Work and IP Defaults
- Infringement
  - Indemnities, Warranties and Liability Caps
  - “Repair or Replace” Indemnity
- IP Ownership vs. Use
  - Pre-Existing Materials
  - Developed Materials
- Works Made for Hire Provisions

Introduction

- **Context and Perspective**
  - Commercial contracts with important IP components
  - IP procurement not a primary business objective – but IP assets are critical to achieving the primary objectives
  - IP issues are important, but are not critical business drivers

Introduction

- **Purpose and Objective**
  - Identify IP issues that frequently arise in commercial contracts
  - Discuss the typical underlying business drivers for these issues
  - Present practical options and recommended approaches for addressing these issues

Introduction

- **Provisions Covered**
  - Statement of work and IP defaults
  - Infringement and warranties, indemnities and liability caps
  - IP ownership vs. use
  - Works made for hire provisions
- **Disclaimer**
  - *Every transaction is unique. Advice and sample provisions are provided for general informational purposes only. These do not constitute legal advice. Any views expressed in this article should not be attributed to Gibson, Dunn & Crutcher LLP, its attorneys, or any of its clients.*

Statements of Work and IP Defaults

- Statements of Work in Context
- Who Owns IT? – IP Rights and Defaults
- Negotiation Issues
- Options for Addressing This Issue
- Recommended Approach

Statements of Work and IP Defaults

- **Statements of Work in Context**
  - Frequently used in commercial technology / services contracts – including where IP is being developed or provided
  - May be called SOW, Description of Services, Product Schedule, Order Form, Services Schedule, Work Order, etc.
  - Typically addresses key commercial issues re. the product in question:
    - What is being purchased?
    - How will it be provided?
    - How much will it cost?
    - **Who owns it (IP Rights)?**

Statements of Work and IP Defaults

- **Who Owns It? – IP Rights and Defaults**
  - Best Case: IP rights are addressed explicitly up front (before contract execution)
  - Not Always Feasible
    - IP rights may not be contentious, but items too numerous to identify in initial contract documents
    - IP rights might be contentious or a wide variety of work product will be produced under multiple SOWs, and IP rights will vary on an item-by-item basis
    - Parties can't reach agreement and punt on contentious IP issues for later negotiation
  - Where not feasible to address IP rights up front, the default IP rights and the SOW are critical

Statements of Work and IP Defaults

- **Negotiation Issues (*things to keep in mind*)**
  - Will future SOWs be for different products or services?
  - Will future SOWs implicate different legal issues/risks? Will products / services be delivered in different jurisdictions, etc.?
  - SOWs are part of the contract documents, and can (in some circumstances) override the legal terms and conditions.
  - SOWs may not be IP documents, but may contain provisions that affect IP rights (assigning right or categorizing work product)
  - SOWs are often drafted, negotiated, and executed with little to no legal supervision.
  - Contract needs to address the "effect of silence" in the SOW

Statements of Work and IP Defaults

- **Negotiation Issues (*things to keep in mind*) (cont.)**
  - Any statement of work that is intended to classify or assign IP rights should be reviewed by legal counsel.
  - If IP rights will be specified in the SOW, then the contract needs to specify the default rights (the effect of silence)
    - These should favor the party least likely to effectively govern the SOW process (typically the customer)
  - The customer will most likely have significantly less leverage during the SOW process than during initial contract negotiations

Statements of Work and IP Defaults

- **Options for Addressing This Issue**
  - IP rights in contract, SOW cannot override
    - Requires up-front negotiation
    - May not be feasible in all situations
    - Requires less strict governance of the SOW process (from the legal perspective)
  - IP rights defaults in contract, SOW can override
    - Requires less up-front negotiation
    - More flexible for longer-term arrangements
    - May require strict legal supervision of SOW process
    - Need to address default IP rights (if SOW fails to specify)

Statements of Work and IP Defaults

- **Recommended Approach**
  - Do not use the SOW as an excuse not to negotiate an issue (particularly one as important as IP rights)
  - Contract should contain default IP rights in favor of the customer (e.g., customer has ownership or unrestricted right to use)
    - Silence in SOW = default in favor of customer
  - Circumstances under which the SOW can override these defaults (or any other defaults) should be strictly limited
    - Clear order of precedence provision
    - May even require separate signature by a specified position
  - Legal needs to impress upon the business the importance of this issue and the role of the legal function in the SOW process

Infringement

- Overview: The Issue
- The Relevant Contract Provisions
  - Indemnities, Warranties and Liability Caps
  - “Repair or Replace” Indemnity
- Negotiation Options and Recommended Approaches

Infringement

- **Issue: Negotiating appropriate remedies for infringement claims**

- Addressed through overlapping provisions that must be viewed and negotiated in concert
  - Representation and Warranty re. Non-Infringement
  - Indemnification for Infringement
  - Limitation of Liability

Infringement

- **Concepts to Keep in Mind**
  - Indemnification is critical – IP infringement is a potentially huge liability.
  - More importantly, it is one over which the customer has virtually no control – no ability to scope or mitigate this risk.
  - The geographic scope of your operations and your intended use of the relevant IP is relevant to the indemnity.
  - Your intended use (specifically re. modifications) is relevant to the indemnity.
  - Whether or not you are the licensor or licensee is relevant to the indemnity. (Licensors more likely to be indemnitors).

Infringement
Indemnities, Warranties and Liability Caps

- **Warranty of Non-Infringement**
  - Many vendors / licensors resist giving both the warranty of non-infringement and the indemnity for non-infringement
  - Greater contract value seems to correspond with less willingness to give non-infringement warranty
  - Probably due to potential remedies for breach of this warranty
    - Breach of contract (esp. termination right)
    - Fraudulent Misrepresentation (typically exception to liability caps)
  - In these cases, vendors / licensors require customers to rely on indemnities

Infringement
Indemnities, Warranties and Liability Caps

- **Issues with Infringement Indemnities**
  - Scope of Indemnity
    - Substantive Scope (IP rights covered)
    - Geographic Scope
    - Carve-outs

Infringement
Indemnities, Warranties and Liability Caps

- **Issues and Recommended Approaches**
  - **Substantive Scope of Indemnity**
    - Vendors often seek to exclude everything except copyright (esp. patent rights)
    - But these can be critical, particularly in light of increasingly aggressive patenting of business methods
    - Recommended Approach: resist limits on the substantive indemnity scope, but focus on geographic restrictions

- **Issues and Recommended Approaches**
  - **Geographic Scope**
    - Geographic limitations (e.g., indemnities only covering US IP rights) are common
    - Typically more important to the vendor than the customer
    - Recommended Approach: Geographic limitations can be acceptable, if they make sense given your operational footprint

Infringement
Indemnities, Warranties and Liability Caps

- **Issues and Recommended Approaches**
  - **Carve-outs**
    - Standard carve-outs (e.g., for infringement caused by your own modifications to the IP) are generally acceptable
    - But make sure these carve-outs are consistent with your intended use of the IP

Infringement
Indemnities, Warranties and Liability Caps

- **Issues with Infringement Indemnities**
  - Uncapped vs. Capped Liability
  - Consequential Damages Limitation
    - Indemnified losses excluded from any limitation on consequential damages, or
    - Amounts paid to any third party under the indemnity are deemed to be direct damages of the indemnitee, even if they are consequential damages to the third party

Infringement
"Repair or Replace" Indemnity

- **Overview**
  - Typically given by licensors of software and other types of IP
  - If the IP is infringing, then the licensor either:
    - Modifies it (to be non-infringing), or
    - Replaces it (with something equivalent, but non-infringing)
  - If neither are possible, then the licensor removes the IP and certain customer rights may apply:
    - Right to refund (sometimes amortized)
    - Right to terminate (without cost)

Infringement
"Repair or Replace" Indemnity

- **Key Issues:**
  - "Repair or Replace" should always be in addition to the general infringement indemnity – not a sole and exclusive remedy
  - Contract should specify that any modification or replacement meets all original functionality requirements
  - Customer should request right of (reasonable) approval over modifications or replacements
  - Right to terminate may not be required, but right to refund (or equitable reduction of charges) is necessary
  - Any amortization formula for the refunded fees should take into account the customer's cost to replace the item or vendor
    - Short-term, straight-line depreciation not always appropriate

IP Ownership vs. Use

- Context and Overview
- Pre-Existing Materials
  - Key Business Drivers
  - Options and Issues
  - Recommended Approach
- Developed Materials
  - Key Business Drivers
  - Options and Issues
  - Recommended Approach

IP Ownership vs. Use
Context and Overview

- **Ownership, Rights of Use, and Emotional Baggage**
  - Discussions of IP ownership vs. use often complicated by various factors:
    - Many complex technical legal issues are entailed in IP ownership vs. license rights
    - Relevant laws are territorial, and may vary by jurisdiction (and many deals are multi-national in scope)
    - There tends to be lots of "emotional baggage" around the idea of ownership of IP
      - "We built it, we own it."
      - "We paid for it, we own it."

IP Ownership vs. Use
Context and Overview

- **Ownership, Rights of Use, and Emotional Baggage (cont.)**
  - **Need to pull back and focus on the underlying business drivers and objectives**
    - **Good business guidance can be hard to come by**
      - **Complex issues means that "gut instincts" re. ownership aren't that useful in the IP context**
      - **Simple solutions are not always that effective**
        - » **Example: joint ownership entails rights and obligations that might easily be inconsistent with the parties' business objectives**

IP Ownership vs. Use
Context and Overview

- **Underlying Business Drivers and Issues**

Example Customer-Side Business Objectives	Example Vendor-Side Business Objectives
• Use the IP in ongoing business operations (always)	• Commercialize the IP (always)
• Prevent competitors from using the IP (sometimes)	• Protect confidential information (always)
• Protect confidential information (always)	• Use the IP with other customers (almost always)
• Commercialize the IP (sometimes)	• Prevent competitors from using the IP (almost always)

IP Ownership vs. Use
Context and Overview

- **Framework for Analysis**
  - Objective: Allocate IP rights in a way that makes sense given the parties' business objectives
  - Analytical Framework / Process:
    - Identify the IP at issue
    - Identify the parties' business needs and objectives
    - Identify the IP rights necessary to meet those needs and objectives
    - Allocate the IP rights through ownership and licensing

IP Ownership vs. Use
Context and Overview

- **Framework for Analysis (cont.)**
  - Keep in mind:
    - Need to get beyond the "We own what we [build] [buy]" thinking
    - Overly simple solutions can be problematic (e.g., joint ownership) – KISS isn't necessarily the way to go

IP Ownership vs. Use
Developed Materials

- Ownership vs. use issues are most obviously present in the context of developed materials
- Example: Financial Services Company vs. ERP Vendor
  - Customer contracting with ERP vendor to develop new modules
  - Both sides held firm philosophies on ownership - negotiations quickly stalled
  - But business interests were relatively compatible
  - ERP owned, with temporary exclusive license to customer
  - Customer licensed, with commitments by vendor to commercialize and support
  - Basically win-win – key was to get past the “we build we own vs. we buy we own” divide

IP Ownership vs. Use
Pre-Existing Materials

- **Options and Issues**
  - Negotiations over ownership of Pre-Existing Materials usually straightforward – the party bringing the PEM to the table retains ownership
  - Issues arise over:
    - Collaborative projects, where it may be difficult to determine who brought something to the table
    - Derivative works
    - Embedded IP

IP Ownership vs. Use
Pre-Existing Materials

- **Options and Issues (cont.)**
  - Option 1:
    - Party bringing PEM retains ownership of PEM and all derivative works (regardless of who creates/contributes to the derivative work)
    - Other party gets license to PEM during term, perpetual license to derivative works it creates/contributes to, and perpetual license to PEM as necessary to use derivative works
    - Factors to consider:
      - Long term dependency (by customer) and difficulty of proving contributions to derivative works
      - Possible need to exclude use by competitors (usually for limited time period)

IP Ownership vs. Use
Pre-Existing Materials

- **Options and Issues (cont.)**
  - Option 2:
    - Party bringing PEM retains ownership of PEM
    - Party creating derivative works owns them and licenses back to PEM owner (with possible restrictions re. use by competitors, etc.)
    - Factors to consider:
      - Long term dependency (by customer) on PEM of vendor
      - Possible need to exclude use by competitors (usually for limited time period)

IP Ownership vs. Use
Pre-Existing Materials

- **Recommended Approach**
  - Option 1 (party bringing PEM retains ownership of PEM and all derivative works, but licenses back use of derivative works to the creator/contributor)
  - With some caveats:
    - Keep in mind the context here (customer-side representation)
    - Keep in mind it may be difficult to tease out contributions to derivative works
    - For certain critical IP assets, don't depend on "rules" but call out the rights separately and explicitly
    - Also, specify the format of the IP to be provided
    - Example: Help desk scripts (ownership, use and HTML vs. hard copy)

Works Made for Hire Provisions

- **Potential Risks**
  - Work-for-hire sounds a lot simpler than it is
  - Work-for-hire laws vary by jurisdiction (example: US and UK)
  - Work-for-hire definitions are complex, driven by statute, and often do not apply to the type of work done in many commercial technology contracts (particularly services contracts where incidental IP is being developed)
  - If a work-for-hire clause is found to be inapplicable, then the author will likely own the IP (the customer might have a limited, implied license)

Works Made for Hire Provisions

- **Recommended Approach:**
  - Fairly simple to address
  - Always use the two-pronged approach:
    - Work-for-hire clause
    - Present assignment of IP rights in the event the work-for-hire clause is inapplicable (coupled with commitment to assign IP rights for future IP)

Thank You, and Questions