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Bylined Article

Why IP Does Matter: You Can Avoid Unexpected Business Disadvantages (Part I)

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The reflexive IP position that the company that pays for custom software should own the software can result in an unfavorable — but avoidable — business outcome. This article discusses how and why the decisions as to whether a company should have license instead of ownership rights should be decided by the business drivers underlying the deal. Using this framework will reduce the time and expense of negotiating agreements, and will allow a company to save "negotiating points" and instead use them to secure other important business rights and remedies.

Let's assume that the custom software is a layer of programming that will sit on top of the provider's standard offering. Let's further assume that the custom software cannot operate without the base layer, and that because it is not a standalone product, it cannot be sold to third parties because it will be of no utility without the provider's base product. If the customer insists on owning custom software, the following results are likely: (1) it will not be written by the provider's "A Team;" (2) it will not necessarily integrate well with the provider's base product; (3) it will not receive top level support and maintenance through the life of the contract; (4) it will require ongoing revisions as the base product evolves – thus resulting in unpredictable future costs; and (5) because the provider cannot resell it to future customers, absent special circumstances, it will be an orphan product. Put another way, requiring the provider to relinquish ownership of custom software that it would otherwise resell to future customers creates disincentives for the provider to do its best job in writing and supporting the software. Therefore, if the customer will not use the customer software outside of the outsourcing services provided by the vendor, and if, for example, the customer does not plan to monetize the enhancements by licensing them to others, then it will have paid a premium to own software when instead it could have received a sufficiently broad license to use the software at no or a lower cost.

If the customer allows the provider to own the customer software programs, the following advantages are likely to result: (1) the provider can relicense them to other customers, and therefore will have a greater incentive to write them better and so that they fully integrate with the standard service offerings; (2) they will be covered by the SLAs, KPIs and so forth; (3) because the provider may incorporate them or a modified version of them into its standard service offerings, the cost of creating them to the pioneer customer should be lower; (4) they will be updated as the rest of the service offering evolves over time, and thus stay integrated; and (5) significantly from a legal risk mitigation perspective, they are most likely to be covered by both the provider's performance and the IP representations, warranties, covenants and indemnities.

These IP contract provisions will give the customer protection if a lawsuit is brought alleging patent or other IP infringement — something very possible in the world of patent troll litigation. The outsource provider, as the IP indemnitor, will have the obligation to defend the lawsuit, and/or pay a license fee to continuing using the software, at its expense. If the software has to be redesigned to avoid infringement, then the provider will bear that cost as well.

However, when should the customer retain ownership of custom software it commissions? Returning to the framework that the allocation of ownership and license rights should be decided based upon the business drivers of the transaction, there are reasons why the benefits of the customer owning the customer software (or similar enhancements) are outweighed by the disadvantages.

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If the customer is seeking IT-enabled business transformation, then the customer needs to decide whether the enhancements are more like back-office IT or more like the IP it needs to own so that it can integrate them into other parts of its business that are not part of the provider's services and that it needs them to continue the transformation after the expiration of the agreement. If the customer entered into the agreement to obtain IP to gain a competitive advantage over its competitors, then ownership would prevent the provider from providing the same technology to the competitors.

A middle ground, which should be reflected in the price, is to allow the provider to license the enhancements to third parties that the customer does not consider to be existing or potential competitors. In any event, if the customer does not own the enhancements and the IP therein, it may need a license to sublicense the enhancements to its other providers in order for them to provide their services to the customer and/or it may need the right to sublicense the enhancements to the customer's customers. Ownership would automatically provide those

rights. Finally, if the customer will need to make derivative works of the enhancements, it will need to own the enhancements or have a sufficient IP license to do so. If the right to do so is a license right, the questions are whether the customer or the provider will own the derivate works, and if licensed, whether the customer will have the right to sublicense derivative works owned by the provider.

In conclusion, the customer's decision to obtain ownership or a license to custom enhancements should be driven by the customer's business objectives both inside and outside of the outsourcing transactions.

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