



## Protecting Intellectual Property from Trading Risks

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*The current financial environment has placed increased pressure on many firms and, unfortunately, caused a number of businesses to collapse. This article outlines an ownership model that software firms can utilise to protect their intellectual property in such a situation.*

When a company or individual becomes insolvent, their assets are typically seized or sold to pay off creditors. For software developers, this can mean losing ownership of their source code.

Other valuable intellectual property owned by the insolvent entity (or its guarantors) could also be lost, including domain names, trade marks, documentation, customer lists and client data.

For someone who has spent a lot of time, money and effort developing their software and brand, losing ownership of “irreplaceable” intellectual property could be more damaging than losing replaceable tangible assets.

Fortunately, software owners can mitigate this risk by separating the ownership of intellectual property from day-to-day trading risks, so that one legal entity is responsible for commercial trading with the software, while a separate legal entity owns the intellectual property. The aim is to ensure that if the trading entity becomes insolvent, the intellectual property is protected by virtue of it being owned by a separate legal entity, and therefore out of reach of a claim against the trading entity.

Separating assets and parts of a business into two or more entities is relatively common; for example, business owners and professionals commonly put their houses and personal assets into a trust. Franchisors also commonly use separate trading and licensing entities. However, software developers

sometimes overlook this concept as a way to protect their software and related assets.

To understand how a separate-ownership model can work for a software firm, it is useful to briefly consider that most software owners do not actually “sell” software, but license it. That is, the developer (via a licence) grants each customer the non-exclusive right to use the software. This use is subject to terms and conditions contained in the licence. The software remains owned by the original owner.

### Example of separate-ownership model

An example of a separate-ownership model (using two limited liability companies) is as follows:

- Two companies are formed – HoldingCo Limited and TradingCo Limited.
- HoldingCo Limited owns the intellectual property (e.g. the software, domain names).
- HoldingCo licenses the intellectual property to TradingCo on terms that allow TradingCo to sub-license the software to end users, and use the trade marks and other intellectual property (referred to as the “head licence”).
- TradingCo markets and licenses the software to customers. HoldingCo, on the other hand, has no dealings with customers.

There are some important points to add to this example:

- Only TradingCo should actually trade (e.g. deal with customers, market the software, etc). HoldingCo should have no external dealings (or as few as possible). This will minimise the exposure of HoldingCo (which owns the intellectual property) to legal liability.
- If TradingCo becomes insolvent, its liability will be limited to its own assets – not any of the intellectual property owned by HoldingCo. However, if TradingCo itself owned HoldingCo, then TradingCo would effectively own the intellectual property, which would defeat the purpose of the separation.
- Similarly, if HoldingCo (or its shareholder) guaranteed TradingCo, the intellectual property would be exposed to TradingCo's risks.
- The licence between HoldingCo and TradingCo should be properly documented and terminate if certain events occur (discussed below).
- Because it is common for software and related intellectual property to be continually developed and extended, all new intellectual property should also be protected. This can be achieved by appropriate terms in the licence that automatically transfer (and license-back) any new intellectual property from TradingCo to HoldingCo.

There may also be other important issues depending on specific circumstances.

### **If the trading entity gets into trouble**

In our example, a collapse of TradingCo would not put the assets of HoldingCo at risk.

However, if HoldingCo's license of its intellectual property to TradingCo (the head licence) was not structured and documented appropriately, a third party could potentially gain control of the head licence. Even worse, if the head licence created a world-wide, royalty-free license to use the intellectual property, the effect could be comparable to losing ownership of the intellectual property altogether.

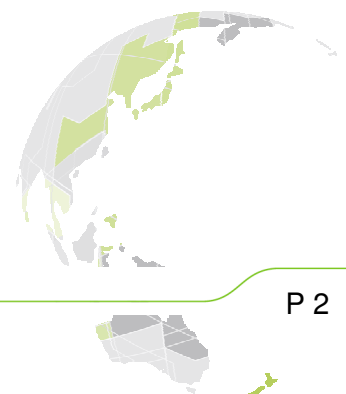
Accordingly, the head licence should be set to automatically terminate if TradingCo becomes insolvent or other adverse events occur. The head licence could also allow the licensor (HoldingCo) to terminate the licence at will.

If necessary, a new company (NewCo Limited) could be set up and HoldingCo could grant a new head licence to NewCo, allowing trading (via NewCo) to resume relatively seamlessly.

### **What entities can be used?**

Our example uses limited liability companies for the two entities. However, other legal entities are suitable in appropriate circumstances, notably trusts for holding intellectual property rights.

In most cases, a limited liability company will be suitable as a holding company (and itself could be held in a trust). Setting up a company in New Zealand is relatively inexpensive and quick.



## Financial considerations

TradingCo, as the trading entity, is likely to generate cash and other assets from its trading activities. A common scenario is to have HoldingCo extract revenues out of TradingCo via a license fee and / or some other fee. By doing so, TradingCo will have less assets in the event of collapse.

Separation of a business into multiple entities can bring other financial benefits, although there are a number of tax and other issues which should be assessed in advance.

## Is the risk real?

Before implementing a separate-ownership model, it is fair to ask: how real is the risk that a software owner could lose their intellectual property? After all, shouldn't a good licence agreement (and insurance) protect the licensor from claims?

Appropriate licences and insurance can remove (or mitigate) many risks for licensors and are certainly key components of risk management.

However, it is the insolvency of a company (or bankruptcy of an individual) that can result in loss of intellectual property assets. Such events can be triggered by slow-paying debtors, excessive borrowing, or any number of other events or misfortunes. It is therefore a risk that all businesses face.

Separate ownership can also make it safer for a developer (via the trading entity) to bring in new investors, or enter into joint ventures and other arrangements with third parties, while ensuring that their existing intellectual property is not put at risk.

## Is it worth it?

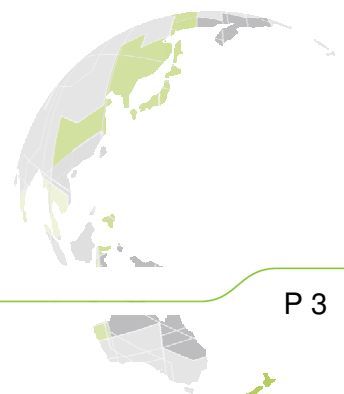
There are good reasons in many cases to implement a separate-ownership model, and many businesses adopt such an approach. The model can provide effective protection for valuable intellectual property while requiring only minor practical changes (if any) to a firm's day-to-day operations.

Some effort is required in setting up the appropriate structure and creating the necessary documentation, and there can be factors requiring special attention, such as:

- Existing licensing and intellectual property ownership arrangements;
- Existing lending security agreements; and
- Shareholder issues.

However, resolving these issues in order to implement a separate-ownership model is usually a one-off task, with occasional reviews and administration recommended. It is also an opportunity to identify any outstanding company and shareholder matters for tidying up at the same time (e.g. adopting or updating a Shareholders' Agreement and a Constitution).

In any case, we recommend undertaking a thorough assessment of all relevant issues, and the pros and cons of your particular circumstances, before taking any steps.



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