

Major Project Risks from IP Issues: Traps for the Unwary

“How can a few lines of code stop this power plant from running?”

By [Jenny Cieplak](#)

Power plants, manufacturing and logistics facilities, and other infrastructure projects are not typically seen as operations in which intellectual property (IP) plays a key role in maintaining continuous functionality. IP of all types is often an afterthought in a lender's due diligence and documentation. Project sponsors may not recognize the need to obtain and protect their rights to use IP which may be essential to their business. Given the state of today's computerized and technology-focused world, however, both project sponsors and lenders should take a careful look at the technology and IP risks inherent in a project and work to assess and mitigate those risks.

In many cases, the project sponsor and the lender will have a common interest in making sure the right provisions are in place to protect a project company's ability to use essential technologies. However, a lender will have to ensure that it has the ability to use key technology in a foreclosure or sale scenario. This article provides a general overview of issues that project sponsors and lenders alike should ensure are addressed for the operational stage of a project, provisions that lenders should be sure are in place

in the event of a foreclosure and subsequent sale of a project, and concerns to look for in due diligence of a project.

This article focuses on IP issues in the United States, where IP protection laws are strong and are generally enforced. Other significant issues can arise when technology is transferred to jurisdictions where IP interests enjoy more limited protection. If IP will be transferred outside of the United States or is being in-licensed from outside of the United States, local counsel will need to be consulted to determine what protections will be available and help the technology owner or licensee assess the risks associated with the transfer or use of the IP.

Project companies can use technologies that are subject to IP protection through copyright, patent or trade secret laws. Software, which is protected by copyright laws and which can also possibly be protected as a trade secret, is used increasingly in the operations of many types of facilities. Software is commonly used to operate and monitor machinery such as wind turbines and conveyor belts, to track consumption of power, and to track delivery mechanisms such as connectivity to the electrical grid.

Patents are the category of IP most often associated with infrastructure projects. Ensuring that a project company has the right to practice any patents that might cover its use of machinery or processes, is essential to ensuring continuous operations. In addition, care should be taken to ensure that a project does not infringe on third-party patents, as injunctions prohibiting infringing operations could also stop a project from operating.

Companies also seek trade secret protection for technologies that deserve the utmost confidentiality or are not otherwise protectable. Formulas such as the composition of fracking fluid, chemical processes, and refining and extraction methods may be protectable as trade secrets. Trade secret protection is often used to protect technologies where infringement is difficult to detect, where protection for a term longer than the patent term is desired, and/or where patent or copyright protection may not be available. Constant vigilance is needed in order to maintain trade secret protection. A trade secret holder must ensure that the secret formula or process is disseminated within the company only to trusted em-

ployees or consultants who have signed nondisclosure agreements or are otherwise subject to policies regarding confidentiality. When disclosing the secret information to third parties such as contract counterparties or financing sources, the information should be similarly subject to a strict confidentiality agreement and should be revealed on a need-to-know basis. Further, in many instances, courts have required that to qualify for trade secret protection, the purported owner of the trade secret must have taken action to physically protect the trade secrets, such as locking the information in a secure location. If the design of a power plant is intended to be kept as a trade secret, for example, protecting the design as a trade secret may also require physical security limiting visitors to the plant.

IP and Technology Concerns for Project Sponsors and Lenders

Ensuring Rights to Use IP

Typically a project company will not hold title to IP itself. Instead IP will usually be licensed either from the project sponsor or a third-party provider. In either case, care should be taken to ensure that the project company has an appropriate license to use the IP to the extent contemplated for the project. IP licenses can be standalone (i.e., the only service the licensor is providing is the right to use the licensed IP), or can be part of a construction, equipment supply, or operations and maintenance agreement.

Where IP is held at the project sponsor level, the sponsor should enter into a separate license agreement with each project company on arms' length terms (including provisions for payment of royalties). Tax and/or valuation experts may be required to determine the appropriate royalty based on the project sponsor's internal valuation of the IP.

If the project sponsor purports to own the IP, it should take care to ensure that it holds valid title to the IP that it will license the project company by ensuring that it has obtained appropriate IP assignment agreements from founders, employees and consultants who have contributed to the devel-

opment of the IP. If a critical contributor later decides to leave the business and has not assigned key IP to the project sponsor, it may be difficult to negotiate a cost-effective transfer of IP. Project sponsors should also consider whether to enter into noncompetition agreements with key IP-contributors so that they are unable to take the ideas behind key IP and use them in competing ventures. If patent protection will be sought for the technology, each inventor will need to execute a separate document to assign the patent application to the entity seeking to own the application, as the Patent Office will require receipt of these separate assignment to assign the patent application and any resulting issued patent to a company entity.

If the IP for the project is to be licensed from an unaffiliated third party, the license will typically be between the project company itself and the licensor. In some cases the licensor may require that the project sponsor guarantee the payment of royalties and other obligations (such as indemnity obligations) in the license. In other cases, the licensor may want to enter into a license agreement with the project sponsor directly. In that case, the project sponsor will need to enter into sublicenses with each project company that will use the IP, and the project sponsor should ensure that the license includes appropriate rights to sublicense the IP to its project companies.

IP licenses from unaffiliated third parties will generally restrict the field in which a project company may use the licensed IP. Typically the project company may only use the IP for the specific project that is contemplated at the time the license is entered into. If it is anticipated that the project will be constructed in stages, or that the facility may expand over time, the licensee should seek to include a provision that would permit expansion of the scope, rather than engaging in a negotiation with the licensor at the time expansion is desired as licensors may either decline to amend the license agreement or attempt to extract additional value for the expansion. This could be done by including an option right in the license agreement with pre-negotiated pricing and other terms that would kick in if the option is exercised.

Key Provisions in Software Licenses

Licensees should confirm that any software license contains provisions requiring the licensor to maintain the software, including fixing code errors as they are identified and providing the most updated versions. If the license does not provide this right, a separate software maintenance agreement may be required. Failure of a key software program can paralyze an entire project's operations. For example, if monitoring software is no longer able to determine when project equipment exceeds its tolerance levels, the plant may become unsafe to operate or may fail to meet mandated regulatory requirements.

A licensor will not typically give the project company or sponsor permission to modify its software (even to fix malfunctioning code), and will only provide the project company with what is known as the "object" or "run-time" code to the software (i.e., the machine-readable format that cannot be edited). However, the project company or sponsor may be able to negotiate an escrow arrangement wherein the licensor deposits the "source code" (the editable code written in a standard programming language) with a trusted escrow provider. Under a standard source code escrow arrangement, if the licensor files for bankruptcy or otherwise ceases to do business or, in certain cases, to fulfill its code maintenance obligations, the licensee (in this case, the project company or sponsor) would have the right to receive the source code and to edit and repair outdated or malfunctioning code. As a practical matter, the licensee may not have the expertise or experience to maintain or repair the code and so other options (such as the right to engage a third-party vendor to host, maintain and repair the software) should also be considered in the course of negotiations.

A Series of Unfortunate Events

As with any other aspect of a project, things can go wrong in the area of IP. Project sponsors, project companies and lenders alike should attempt to mitigate the risks that can arise in the event of a technology- or IP-related issue.

Claims that a project is infringing on a third party's IP can stop a project indefinitely if a court issues an injunction preventing further infringement, or at the least, tie up important resources in litigation for years. For software, equipment and other materials purchased or licensed from third parties, project sponsors (and lenders) should ensure that the license or sale agreement contains provisions to address potential infringement claims. The licensee or transferee should seek a representation that the purchased or licensed technology is non-infringing, as well as a specific indemnity for infringement claims. Licensees often request a provision that would require the licensor or seller to provide a non-infringing version if the technology is later discovered to infringe on third-party IP. Many technology providers resist this requirement, as changing technology to make it non-infringing can range from modifying a few lines of code to completely redesigning a piece of equipment and instead often offer a partial refund of the license fee. However, the alternative—shutting down operations while searching for replacement non-infringing IP—is not an ideal solution for project operators, so this clause is often heavily negotiated.

As part of the development of a project, sponsors can also undertake patent searches and even software code searches to determine if the technology they plan to use could be considered to infringe third-party IP. If a project sponsor has developed a new patentable technology, it should consider whether to apply for a patent in that technology or to maintain it as a trade secret. This calculation is sometimes a difficult one to make, as once an inventor applies for a patent and the application is published, the invention described in the patent application can no longer be protected as a trade secret and thus may be subject to a complete loss of protection if the patent application is denied. However, even if a patent is not granted, publishing the invention will block third parties who later try to obtain patent protection as patent protection is given on a "first to file" basis. That said, prior use of a technology will not prevent a third party from obtaining a patent

and filing a patent infringement claim if the project sponsor's use of the technology remains secret, though a prior use defense to the infringement claim could remain available to the project sponsor.

Certain processes and formulas are maintained by project sponsors as trade secrets rather than patented, as patent protection expires after a set time (most typically 15 or 20 years from the date of filing depending on the type of patent) and thereafter are usable by anyone. Software may also be protected as a trade secret if it is maintained in confidence. Trade secret protection is easily lost, however. If the secret technology becomes public knowledge, it is no longer protectable as a trade secret. Trade secret protection is also of little use against a third party who has independently developed competing technology. Loss of trade secret protection may not derail a project, but it can make a project less profitable as others rush to exploit the technology. Project sponsors and lenders should be especially careful when working with governmental authorities that may require disclosure of new technologies (such as the content of fracking fluids, which is currently mandated by a number of U.S. states), either to the public or to the governmental agency, which may not be as careful with secret information as the owner.

If a licensor becomes the subject of a bankruptcy proceeding, it has the right to assume or reject executory contracts, including most IP licenses. However, Section 365(n) of the U.S. Bankruptcy Code provides special protection for IP licenses. If the bankrupt licensor or its trustee rejects a license, under Section 365(n) a licensee can elect to retain its rights to the licensed IP. In return, the licensee must continue to make any required royalty payment. The licensee also can retain rights under any agreement supplementary to the license, which should include source code or other forms of technology escrow agreements. Project sponsors (and lenders) should ensure that technology licenses specifically state that they are subject to Section 365(n). Such a provision, although not binding on the bankruptcy court, is helpful in ensuring that a bankruptcy court or trustee will be

persuaded that the bankrupt licensor may not reject the license. Note that Section 365(n) will not, however, require the licensor to perform any services, such as maintenance of provision of updates. Given that in many cases licenses to project companies are embedded in other services contracts, project sponsors and lenders should also ensure that should a key service or equipment provider go bankrupt, another provider is available to take its place. Even where the only service provided by the licensor is continued maintenance of the IP (such as fixing bugs in software), the project company should obtain a source code escrow with the right to maintain the software itself or to hire a third party to do so in the event the licensor enters bankruptcy.

IP and Technology Concerns in a Foreclosure Scenario

In addition to the concerns outlined above, a project lender will want to ensure that it has additional protections in the event the project company defaults on its obligations. Following a default, the lender may permit the project company to continue to operate the project, but often the lender will want to be able to step in and take over if the project company proves itself unable to continue operations in a manner that ensures a consistent revenue stream. Lenders should look to include a number of protective provisions in their agreements with debtors to ensure that they have sufficient IP rights to operate the project without interruption in a foreclosure scenario.

Third-Party License Protections

While a project lender will want to confirm that its agreements with the debtor provide the lender with a security interest in the IP (including licenses) necessary to operate the project, a security interest is not enough. While the Uniform Commercial Code permits a lender to obtain a security interest in and "foreclose" on an IP license, preventing the debtor from exercising rights thereunder, a foreclosing lender cannot enforce the license against the licensor unless the license permits it to do so. IP licenses typically prohibit the licensee

from assigning the license to an unaffiliated third party. While in the United States the Uniform Commercial Code states that such a prohibition cannot be used to prevent a licensee from granting a security interest in a license, case law is unsettled as to whether a lender who forecloses on this lien can enforce the license (in which case the lender's rights are limited to the proceeds of the license if it is transferred or sold). Therefore, lenders often seek to have licensors of key technology consent to the assignment of the license in the event the lender has the right to initiate foreclosure proceedings against the licensee.

Typically, lenders will go further and insist that the licensor execute a consent to collateral assignment granting the lender affirmative "step-in rights." This document serves as an agreement by the licensor that the lender will be permitted to enforce the license upon a foreclosure where it operates the project. The lender will also want the right to "step out" if the lender desires that the project company or sponsor resume operation of the project, so that the lender does not maintain continued responsibility for the obligations under the license. The lender will also want the licensor to agree that the license may be transferred if the lender sells the entire project in a foreclosure or similar process.

The consent also generally includes other provisions protecting the lender, such as a prohibition on amending the license without the lender's written consent. In addition, the lender will also want to have the right to cure any breach or default under the license on the part of the project company, with additional cure periods extending after the expiration of any cure period in favor of the project company. In a typical case, any expenses incurred by the lender in curing any default will become obligations of the project company under its financing documents.

Project sponsors will often be required to act as broker between the lender and the licensor in negotiating step-in and related rights in the consent. Some licensors may have little to no experience with the requirements of project finance lenders, and will need to be educated both about

the need for the lenders to have such rights as well as the ability of the lenders to understand licensed technology and abide by license terms.

Project sponsors should also take into account a potential foreclosure and the exercise of lender step-in rights when structuring their licensing arrangements generally. A sponsor may want to avoid a hub-and-spoke model where the sponsor is the party to the inbound license, granting sublicenses to its individual project companies. While this may seem to be an efficient arrangement, if a project enters foreclosure or a lender wants to exercise step-in rights, this will be easier to facilitate if the project company is a direct counterparty to the third-party license. If the third-party licensor requires the project sponsor to guarantee the obligations of the project company under the license, the licensee should seek to have the agreement provide that this guarantee automatically terminates if the license is transferred in a foreclosure sale. In addition, lenders are likely to insist that the project company be party to the main license agreement (as opposed to a sublicense), as lenders will not want to take the risk of sponsor non-performance or bankruptcy.

Additional Issues in Sponsor Licenses

Lenders will want to ensure that licenses from project sponsors to project companies include the same step-in rights for the lender that would be included in a typical third-party license. In addition, licenses from project sponsors should otherwise be on arms' length terms. This is especially important should a foreclosure occur, where a project sponsor may find itself in a licensing relationship with a nonaffiliated third party. Payment provisions, including provisions related to taxes, should be clearly laid out and should not be reflective of intercompany discounts. Indemnification and limitation on liability provisions are also important, as are restrictions on the field in which the licensed IP can be used. The project sponsor should take into account the possibility that the project will cease to be operated by an affiliate in its initial drafting of the license. When foreclosure looms it will be too late to make significant changes (and a lender is

likely to prohibit any changes for the benefit of the project sponsor).

Matters to Consider Before a Financing

In addition to negotiating the above provisions, project sponsors and lenders should work together to make sure the lender understands the technology and IP that will be used in the project and the various third-party rights and licenses that will be required. Ensuring that the lender has a good basis for understanding the project's technology will not only make the lender more comfortable with the project overall, but it will also enable the lender and the project company to reach the best solution for the many technology issues that can arise in connection with a project.

Project sponsors should be forthcoming with lenders regarding technology and IP due diligence. For example, if the project sponsor has conducted a patent search prior to engaging with the lender, the sponsor should consider sharing the results of that search with the lender. Lenders also may wish to conduct additional diligence on providers of key technology. Project sponsors should use reasonable efforts to facilitate that diligence. If a lender is being engaged at the start of the project, that lender may want to review and comment on license agreements.

Technology and IP issues are just one aspect of the complex negotiations parties must work through in any project financing transaction, but if ignored they can have a significant impact or even put a halt to operations when problems arise and must be resolved. In order to take full advantage of a project financing opportunity, sponsors need to invest time and resources before construction starts to work through not only traditional "project" issues such as construction and loan terms, but also factors such as technology and intellectual property concerns that could impact the ongoing operations of a project. Negotiating agreements to forestall these concerns will help lay the foundation of successful operations for years to come.

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