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Special Licensing Issues Involved with Spin-Outs: Joint IP, Cross-Licensing and More

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I. What is a Spin-Out?

In a Spin-Out, certain assets of an existing entity are transferred to a newly formed subsidiary of that entity, and the stock of the subsidiary is distributed either to shareholders of the existing entity or to a third party providing financing or other contributions. Stock may also be retained by the existing entity, but not enough to retain control over the new entity. This type of transaction can also be called a Spin-off or a Split-off. Typically, in the technology industry, the assets transferred in a Spin-Out include intellectual property.

From an intellectual property perspective, a Spin-Out can be viewed as one mechanism to transfer Intellectual Property. There is a continuum of possible structures to exploit intellectual property with third parties, with the Spin-Out generally being one of the most complex.

Continuum of Transactions to Exploit Intellectual Property

	License Transaction	Joint Venture Transaction	Spin Out Transaction
Pros	<ul style="list-style-type: none">• Least Complex• No investment required• No asset transfer required• Retained control of Intellectual Property• Revenues from royalties	<ul style="list-style-type: none">• Expertise/Contributions of third party• Retain ability to influence direction of research/products	<ul style="list-style-type: none">• Ownership for employees possible
Cons	<ul style="list-style-type: none">• No ownership for employees	<ul style="list-style-type: none">• Potential for disputes among stakeholders• Less control over Intellectual Property• Very complex	<ul style="list-style-type: none">• Loss of control of Intellectual Property• Very complex.

This paper presents an analytical approach for structuring and documenting the allocation and transfer of intellectual property rights in the context of a Spin-Out transaction and discusses related issues, including the enforcement of intellectual property rights and the impact of an acquisition, bankruptcy, or dissolution of the spin-out entity.

II. Goals of a Spin-out

Given that a Spin-Out is one of the most complex transactions on the Intellectual Property transfer continuum above, it might be reasonable to wonder why a company would ever choose a Spin-Out over simply licensing the intellectual property. The license approach requires the least effort and has the potential to bring in royalty payments.

However, there are several potential advantages to a Spin-Out. First, every company has limited resources. Therefore, each company needs to focus on research and development that aligns

with its strategic direction. Often corporate R&D develops intellectual property that has value, but that is not aligned with the primary business objectives. Time spent developing, maintaining, and improving such intellectual property takes away from time that could be spent on strategic intellectual property, and may have the effect of distracting the company from its strategic goals.

Similarly, intellectual property that is not aligned with a company's strategic objectives will generally have less value to the company, and generate a lower rate of return, than its strategic intellectual property. Non-strategic intellectual property may have more value in the hands of a new entity that will invest the capital and other resources needed to fully develop and commercialize it, perhaps by using it for applications or in markets that are beyond its current owner's expertise or interests. Finally, by conducting a Spin-Out the company can deliver value directly to its shareholders, reduce its fixed costs, and give employees working on the transferred intellectual property a greater opportunity to participate in the potential economic benefits of exploiting the intellectual property (through stock options, restricted stock, and the like). In some cases, the company doing a Spin-Out anticipates that it will reacquire the new entity after the intellectual property has been fully developed by a more incentivized group of employees.

In sum, a company is likely to choose a Spin-Out transaction when it has intellectual property that is valuable, but that is not strategic or the source of a competitive advantage. In this case, a Spin-Out will enable the company to focus its research and development efforts in areas of the highest potential return, deliver immediate value to its shareholders, and provide greater incentives to its employees.

III. Hypothetical Spin-Out Transaction

For purposes of the discussion that follows, let us consider a simple but realistic hypothetical transaction involving a mythical company called Vertically Integrated Consumer Electronics Corporation or "VICE" for short. VICE's main products are handheld devices marketed to professional sports gamblers that are designed to obtain, through wireless internet connections, continuous real-time updates on the activities – both on and off the field – of all teams, athletes, coaches, and officials designated by the user and to make recommendations for "can't miss" wagers (all with appropriate legal disclaimers contained in a clickwrap license the user must accept the first time the device is turned on and then never sees again).

The key components of these products, which are known as "iTeasers", are (1) an application specific integrated circuit ("ASIC") with proprietary firmware specially designed to perform the combination of analytic functions required by the product – web crawling, filtering, and analysis of the vast amount of available data regarding the user's designated "subjects" (the aforesaid athletes, coaches, and officials) from sources such as ESPN, Twitter, and police departments across the country – and (2) a special high-capacity, low-power memory chip to store all this data. VICE has its own semiconductor fabrication facilities in Taiwan and Singapore at which it produces the ASICs and memory chips using the proprietary "SS" (secret sauce) process technology.

VICE is a publicly traded company with a market cap of roughly \$1.1 billion. It has recently reported an unprecedented ten-fold increase in its annual revenues after its iTeasers alerted their

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