

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

---

## **Municipal Bond Projects: Intellectual Property Risks - ArentFox Schiff**

**Private activity bonds may finance projects that rely on novel technology subject to intellectual property protections, such as patents, trade secrets, and know-how.**

The novelty of the technology presents unique risks for bond buyers, as these projects often represent initial efforts to commercialize previously untested technology at a production scale. Technology that looked promising on paper or even performed on a small experimental scale may not work, or may not deliver the projected economic output, once scaled up to production levels. Resolving engineering issues can be time-consuming and capital-intensive, resulting in capital needs far exceeding the initial projections.

As a result, bondholders should be particularly mindful of their ability to exercise remedies, if not to take possession of the project, then at least in order to have leverage in a workout.

If the collateral package securing the bonds does not properly capture intellectual property rights, the collateral package is virtually worthless. Foreclosing on a physical production plant without the right to use intellectual property necessary for its operation is pointless because the plant cannot be operated. No one would be interested in purchasing it without the right to use the intellectual property.

A threshold issue in these types of transactions is determining whether the operation of the project relies on protected intellectual property, including by:

1. obtaining representations and warranties relating to intellectual property;
2. searching the public record and to the extent potentially applicable patents or patent applications exist, determining whether they apply to the project and whether workarounds are available; and
3. determining whether trade secrets or know-how are implicated.

The borrower and its affiliates have an incentive to overstate the project's reliance on protected intellectual property to extract value in a workout. We have encountered borrowers who contended that the project could not be operated without licenses of patents owned, not surprisingly, by affiliates of the borrower. However, due diligence established that none of the patented technology was actually used in the project. We have also encountered third parties who claimed that the project relied on trade secrets, only to discover through due diligence that the project consisted entirely of standard commercial equipment used in a standard manner. In those cases, the trustee was able to exercise remedies and resell the project without purchasing licenses.

If protected intellectual property is, in fact, present, the next step is determining its ownership and licensing structure to ensure that upon foreclosure, the right to use the intellectual property will pass to the purchaser.

This is not always the case. Often the owner of the intellectual property is the parent of the borrower. The parent licenses the intellectual property to the borrower, and the borrower pledges

the license to the trustee. This structure – where a mere license is pledged – is very problematic if the license is either **revocable** or **non-transferrable**.

An intellectual property license is considered intangible personal property. It can therefore be foreclosed upon by the trustee and sold together with the physical plant in a single foreclosure sale. Where the license is **transferrable**, the buyer at such foreclosure – whether it is the trustee or a third party purchaser – will acquire rights in the license that are identical to the borrower's rights before the foreclosure. Therefore, the foreclosure buyer would be able to use the licensed intellectual property and enforce the license against the licensor. However, if the license is non-transferable, the licensor could simply ignore the sale of the license. The licensor would be free to enforce its intellectual property rights against the buyer, precluding the buyer from using the intellectual property. This would leave the trustee unable to operate or sell the physical plant.

Critically, the license should explicitly state that it is transferrable, or, as a condition to the bond financing, the licensor should consent to the borrower's grant of a security interest in the license to the trustee **and** agree to recognize any buyer at foreclosure as successor licensee. There is a significant risk that a license silent on the issue of transferability or assignability will be determined by a court to be non-transferrable, rendering the security interest in the license meaningless.

The trustee's security interest is similarly meaningless if the license is transferrable but **revocable**. Because a buyer of a transferrable license in foreclosure receives the same rights that the borrower had in the license, a license that is revocable in the hands of the borrower will also be revocable in the hands of the buyer. The licensor could therefore revoke the license both before or after the foreclosure sale.

Where the intellectual property aspects of the collateral package are defective, common law arguments are often available to protect bondholders. However, our view is that the best bondholder protection is for the intellectual property owner, typically the parent, to grant to the trustee and any future owner of the property a license to use the intellectual property. As a backup to these rights, the owner should also agree that the trustee has the right to grant sub-licenses to any future owner of the property. This method effectively ensures that the intellectual property "runs with" the project through foreclosure and subsequent sales.

In addition, such a direct agreement between the trustee and the licensor would expressly spell out the parties' respective rights and obligations and, for that reason, would be less likely to result in a dispute or litigation than even a properly set up security interest in a robust (transferrable and irrevocable) license.

To the extent these protections are not included when the bonds are issued, it is critical to obtain these protections in a workout as a condition for forbearance or additional funding.

by David L. Dubrow, Mark A. Angeloy

April 1, 2022

© ArentFox Schiff 2022