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QUARTERLY NEWSLETTER

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Forging Ahead: A Glimpse into 2013

CAN YOU SKIP TO THE PART WHERE THE PRINCESS USES HER CELEBRITY STATUS TO ENTER INTO A LICENSING AGREEMENT.

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The Innovative Design Protection Act: Bound for Success or Doomed to Fail?

Matthew L. Seror

On September 12, 2012, Senator Charles E. Schumer introduced the Innovative Design Protection Act of 2012 ("IDPA") in the United States Senate. The IDPA seeks to amend the Copyright Act by expanding the scope of copyright protection to include original and unique fashion designs. The IDPA also seeks to curb the manufacture, importation and sale of copies and knock-offs of high-end fashion designs.

Senator Schumer's bill is actually a modified version of legislation he introduced previously. Other efforts to pass similar legislation in 2007, 2009 and 2011 all failed. The current version of the IDPA has been revised in several significant respects.

I. What is Covered Under the Proposed Legislation

The proposed legislation seeks to protect "fashion designs," defined as:

(A) the appearance as a whole of an article of apparel, including its ornamentation; and

(B) Includes original elements of the article of apparel or the original arrangement or placement of original or non-original elements as incorporated in the overall appearance of the article of apparel that –

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Strategic Licensing Considerations

Vicki Dallas

Strategic licensing by companies to expand their brands into new product categories is a growing trend. Additionally, celebrities are now, more than ever, creating their own brands and entering into licensing arrangements to promote their celebrity status.

Strategic licensing arrangements enable a licensor to forge alliances with licensees who have expertise and presence in a particular brand category, thereby leveraging the licensee's existing relationships. For example, licensing enables a licensor to off-load the manufacture and marketing costs of product categories that are not part of a licensor's core business, open up new distribution channels, create new markets in new geographic areas, and extend core products into complementary products that might not otherwise be available.

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New Faces

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Points from the President

RICK COHEN

Several of the articles in this issue focus on protection—protection of the assets in your estate, protection of your company's intellectual property, protection of assets in bankruptcy, and an analysis of the Innovative Design Protection Act.

In "You Built It, Don't Lose It," Steven Fox, of our tax and estate planning practice, details the dramatic changes to estate tax laws that go into effect with the New Year. Farah Bhatti and Jessie Reider explain how—and when—to protect the intellectual property assets in your fashion company. Joseph Welch cautions banks and credit unions to think twice before walking away from second trust deeds in bankruptcy, and Matthew Seror provides an update on the Innovative Design Protection Act.

This issue also includes pointers on strategic licensing. Vicki Dallas provides a primer on when it's beneficial, and lays out key considerations for evaluating whether a licensing arrangement makes sense.

Got collateral? If so, read Anthony Callobre and Harold Lee's article on what your obligations may be when you're about to dispose of it.

As we head into 2013, we hope that you'll find this issue interesting, and more importantly, useful.

Best wishes for a safe and healthy holiday season,

Rick Cohen
President and Chief Executive Officer

Think Again Before Walking Away from Second Trust Deeds in Bankruptcy

Joseph M. Welch

Banks and credit unions routinely walk away from second trust deeds where there isn't enough equity to cover the outstanding loan balance plus interest, arrears, costs of sale and attorneys' fees. This is especially true where the borrower files a chapter 13 bankruptcy case, which allows certain secured liens to be completely avoided.[1]

But there is no reason for banks or credit unions to unknowingly and prematurely walk away from second trust deeds that are given special protections in bankruptcy.

The problem for borrowers who file a chapter 13 bankruptcy case is the "anti-modification provision" of Bankruptcy Code section 1322(b)(2), which protects second trust deed holders from having their loans modified if both:
(1) the property securing the lien is the debtor's principal residence and
(2) there is any value, even $1, to support the lien.[2]

Expected Procedure in Chapter 13 Cases
In practice, a debtor may file a chapter 13 case and move the court to avoid her second trust deed on 14 to 21 days' notice. These motions are usually supported by a declaration of the debtor stating some self-serving belief that her residence is worth a few thousand dollars less than the amount owed on the first trust deed (so as to avoid the anti-modification provision). Prudent banks and credit unions will
(1) quickly determine whether there is any equity to support their second trust deeds[3] and
(2) if so, file an opposition to the debtor's motion (often due within 7 to 14 days of the notice) and request an opportunity to appraise the property.

Bankruptcy courts typically respond to objections by continuing the hearing on debtor's motion and setting an "evidentiary hearing" to allow the parties to file declarations of appraisers (with full appraisal reports) and request cross-examination of the other side's appraiser. These evidentiary hearings can be costly and extremely risky to both sides (and the judges often disdain hearing them). In essence, if the bankruptcy court finds any equity to support the second trust deed then the entire loan is preserved. But if the court finds no equity, then the entire loan is avoided. In essence, bankruptcy law creates an all-or nothing proposition that often can (and should) be avoided.

Striking Deals to Get Around the All-or-Nothing Proposition
With increased frequency, informed banks and credit unions make deals with borrowers to reduce the cost and risk of evidentiary hearings for both sides. For example, on a $100,000 Home Equity Line of Credit with a 10 percent interest rate, the bank or credit union may agree to payments of $1,000/month over five years in full satisfaction of the note,[4] netting $60,000 on the loan and giving the debtor substantial debt relief through an effectively interest-free loan that is satisfied in five years—instead of 15-30 years—where total payments are less than half of what would otherwise be required under the promissory note. Banks and credit unions understandably prefer payments while the debtor (who likely filed chapter 13 and a motion to avoid the second trust deed in order to save her residence) still really wants the property. Striking a reasonable deal can result in the quintessential win-win situation for both sides.

Overcoming Hurdles to Preserve the Deal
In theory, everyone benefits from a deal as outlined above, including the bankruptcy court, for not having to decide an all-or-nothing proposition, other creditors, who generally must be paid more in chapter 13 than a chapter 7 liquidation case, and the chapter 13 trustee, who continues to get commissions on plan payments over 3-5 years. In practice, however, some trustees insist that where payment terms are modified, payments to the bank or credit union on second trust deeds must be made through the plan, with the chapter 13 trustee's commission, often 11 percent, assessed thereon.

Although the bankruptcy code,[5] local bankruptcy rules[6] and trustee guidelines[7] in the Central District of California all suggest direct payments in these instances is proper, trustees (and judges) may be reluctant to allow this out-of-the-box approach. This is true despite relevant appellate law giving bankruptcy courts considerable discretion in allowing these practical deals in chapter 13 plans and requiring articulated standards whenever direct payments are not allowed.[8]

Even in these instances in which the trustee and court are reluctant to allow direct payments from the debtor to the bank or credit union, opposing counsel will often agree to either dismiss the chapter 13 case or convert it to one under chapter 7. By doing so, **the debtor keeps her property (which is usually the reason for filing chapter 13 in the first place) and the bank or credit union gets payments in a deal that substantially benefits both sides** (and often only financially hurts the trustee and certain unsecured and/or priority creditors).

Summary
There is no reason for banks or credit unions to unknowingly and prematurely walk away from second trust deeds that are given special protections in bankruptcy. As outlined above, bankruptcy does not have to be all-or-nothing. Instead, striking a deal early in a bankruptcy case can avoid a costly and risky evidentiary hearing and result in regular monthly mortgage payments, as well as an increased bottom-line, especially where most banks and credit unions would still prefer payments over property.

1 Note: Secured liens in chapter 7 (liquidation) cases generally pass through unaffected, so, to avoid second trust deeds in bankruptcy, debtors must generally file a chapter 13 (reorganization) case and a motion or adversary case. *See Dewsnup v. Timm*, 502 U.S. 410, 418 (1992) and Federal Rule of Bankruptcy Procedure 3012 and 7001(2).
2 *See Lam v. Investors Thrift (In re Lam)*, 211 B.R. 36, 40-41 (9th Cir. B.A.P. 1997) and *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220, 1227 (9th Cir. 2002).
3 Costs of sale are not considered where the debtor intends to keep her property. *Taffi v. United States (In re Taffi)*, 68 F.3d 306, 309-310 (9th Cir. 1995).
4 Pending completion of payments under a settlement, the lien remains valid and, only if and when the debtor makes all agreed-upon payments, will the second trust deed be reconveyed.
5 11 U.S.C. §§ 1322(a)(1) and 1326(c) limit required plan payments to those "necessary for the execution of the plan" and specifically contemplate that certain payments will not be made by the trustee.
6 Local Bankruptcy Rule 3015-1(m)(3) in the Central District of California allows the debtor to elect to pay post-petition mortgage payments through the plan.
7 Many chapter 13 trustees publish guidelines that specifically address (and authorize) direct payments to secured creditors. In addition, the handbook for chapter 7 trustees issued by the United States Trustee admonishes trustees to not administer fully secured assets of nominal value to the estate. See, e.g., sections 6.A., 8.D and 8.K.4 of the U.S. Trustee handbook available online.
8 *See Lopez v. Cohen (In re Lopez)*, 372 B.R. 40, 56 (9th Cir. B.A.P. 2007), *aff'd* at 550 F.3d 1202 (9th Cir. 2008) and *Giesbrecht v. Fitzgerald (In re Giesbrecht)*, 429 B.R. 682, 691-692 (9th Cir. B.A.P. 2010).

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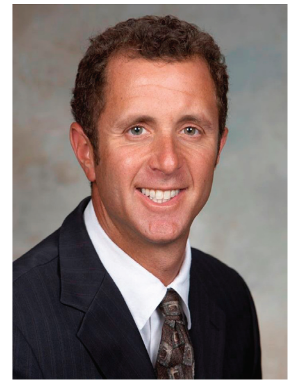

You "Built" It, So Don't Lose It: Estate Tax Laws to Change Dramatically on January 1, 2013

Steven M. Fox

At the end of 2010, Congress passed, and President Obama signed into law, significant changes in the estate, gift and generation-skipping transfer ("GST") tax regime. The 2010 tax legislation extended the so-called "Bush Tax Cuts," but only temporarily through 2012. Beginning January 1, 2013, these tax cuts will expire and the Internal Revenue Code will revert to its 2001 status, unless there is further legislative action to make the 2010 tax changes permanent. **Absent such legislation, on January 1, 2013 the gift and estate tax exemptions are both scheduled to decrease to $1,000,000 from $5,000,000, and the maximum gift and estate tax rates will increase from 35 percent to 55 percent.**

Clients should consider whether and how best to take advantage of the 2010 tax legislation (lock in the $5,000,000 gift exemption before it is lost—**use it before you lose it**) and not wait until 2013 when it may be too late. This Client Tax Alert discusses strategies that a client can embrace to lock in the use of their $5,000,000 gift exemption before it is lost. Depending upon your financial circumstances, the nature of your assets and your intended beneficiaries, one or more of the techniques listed below may be an appropriate way to utilize this expiring gifting opportunity.

Estate, Gift and GST Rates and Exemptions Under the 2010 Tax Legislation

Under the 2010 tax legislation, the estate, gift and GST tax rates all were set at a maximum rate of 35 percent. This is a significant decrease from the 2001 rates of 55 percent. Furthermore, the 2010 tax legislation increased the amounts exempt from these taxes to $5,000,000, indexed for inflation. In addition, the IRS increased the gift tax exemption to the same amount as the estate tax exemption of $5,000,000. The amount for married couples is $10,000,000. **Under current law, until December 31, 2012, a client can make a gift of $5,000,000 without incurring any tax whatsoever. This creates several very attractive strategies for clients.**

Also worthy of note is the fact that both the Gift Tax and Estate Tax Exemptions increased to **$5,120,000** on January 1, 2012, based on the inflation index.

For those clients who have not yet used their lifetime gift exemption of $5,000,000, this a good time to consider making lifetime transfers and lock in the use of all or part of that exemption before it expires on December 31, 2012. This is especially attractive to clients who have real estate that has depreciated in value, or who have seen a decline in the value of their portfolios and bank accounts.

There are a number of ways to take advantage of the increased Gift and GST Tax Exemptions (and lower tax rates) before they are lost:

1. Gifts to "Spousal Gift Trust" for Spouse and/or Other Family Members

A Spousal Gift Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members. Gifting assets to such a trust removes the assets and their future appreciation from your taxable estate. If you are married, a gift to such a trust can be particularly attractive because your spouse can be the primary beneficiary of the trust. **This allows the assets to be removed from your taxable estate while still being available to your spouse.** With careful planning and some restrictions, each spouse can create and fund his or her own Spousal Gift Trust so that each can use their respective $5,000,000 gift exemption. In addition, if you choose to allocate the GST exemption to the gifts to a Spousal Gift Trust, the trust assets and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that the assets will pass free of estate taxes for two or more generations (children and grandchildren). **This Trust may also offer significant asset protection for a client and his or her family.**

2. Gifts to "Dynasty (Legacy) Trust" for Children and Grandchildren

A Dynasty Trust is a trust that is designed to benefit multiple generations (children, grandchildren and great grandchildren) by continuing to hold property in trust for each generation with the assets in the trust not being subject to Estate Tax or GST Tax. The increased Gift Tax Exemption and GST exemption under the 2010 tax legislation present an excellent opportunity to fund a Dynasty Trust using your increased Gift Tax Exemption and allocating the GST Exemption to such gift for the benefit of your descendants. **These Trusts may also be asset protection devices.**

Most states still have statutes that require a trust to terminate within a specified period. Some states, such as Arizona, have modified or repealed these "rules against perpetuities" to allow a trust to continue either for a

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The Innovative Design Protection Act: Bound for Success or Doomed to Fail?

Matthew L. Seror

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(i) are the result of a designer's own creative endeavor; and
(ii) provide a unique, distinguishable, non-trivial and non-utilitarian variation over prior designs for similar types of articles."

Apparel is defined broadly, to include:
(A) an article of men's, women's, or children's clothing, including undergarments, outerwear, gloves, footwear, and headgear;
(B) Handbags, purses, wallets, tote bags, and belts; and
(C) Eyeglass frames.

To be sure, the proposed legislation has been drafted with an extremely broad brush so as to bring a number of items within the scope of the proposed legislation.

II. Key Provisions Included in the IDPA
While the IDPA is proposed as an amendment to the Copyright Act, a number of the provisions represent departures from well-settled practices governing copyright infringement litigation.

Standard for Infringement
The standard for copyright infringement is substantial similarity, meaning that in order for a work to be deemed as infringing on another, it must be substantially similar to the protected work. *Three Boys Music Corp. v. Bolton*, 212 F.3d 477 (9th Cir. 2000) cert denied, 531 U.S. 1126 (2000). The IDPA seeks to modify that standard with regard to fashion designs.

The IDPA provides that the making, importation, offering for sale, sale or distribution for sale or for use in trade, of an infringing article shall be deemed an infringement. An infringing article is any article the design of which has been copied from a design protected by the IDPA without the consent of the owner.

Pretty straightforward so far. But here is where it gets interesting. The IDPA also provides the following exception:

Fashion Designs. In the case of a fashion design, a design shall not be deemed to have been copied from a protected design if that design:
(A) Is not substantially identical in overall visual appearance to and as to the original elements of the protected design; or
(B) Is the result of independent creation.

"Substantially identical" is defined by the IDPA as an article of apparel which is so similar in appearance as to be likely to be mistaken for the protected design, and contains only those differences in construction or design that are merely trivial. If an article that is not "substantially identical" will not be infringing, then it stands to reason that if a design is substantially identical to a protected design, it will be deemed an infringement.

The substantially identical standard represents a departure from existing law—not because of the distinction between substantially similar and substantially identical, but in the way "substantial identicallity" is measured. Under the IDPA a design will be substantially identical—and thereby infringing—if the article of apparel is so similar in appearance as to be likely to be mistaken for the protected design.

But this raises more questions than answers. From whose vantage point is the likely-to-be-mistaken standard applied? From the vantage point of the average consumer? From the vantage point of the consumer who regularly purchases high-end designer garments? The use of this this seemingly objective standard is akin to the likelihood of confusion standard used for trademark infringement and clearly distinguishable from the two-pronged substantially similar standard used in copyright matters, and therefore represents a significant departure from existing copyright law.

Pleading Requirements
The IDPA includes a high pleading requirement for claims for infringement of a fashion design. A claimant suing for infringement must plead with particularity facts that establish:
(1) the fashion design that serves as the basis for the infringement claim;
(2) the design of the defendant that the claimant alleges infringes; and
(3) "the protected design or an image thereof was available in such location or locations, in such a manner, and for such duration that it can be reasonably inferred from the totality of the surrounding facts and circumstances that the defendant saw or otherwise had knowledge of the protected design."

This represents a heightened pleading requirement that a claimant must meet in order to adequately plead a claim for infringement.

III. How Does The Latest Bill Differ From Earlier Versions?
On numerous prior occasions, various forms of the IDPA have been introduced to Congress. So what makes the current

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legislation different and why might this pass when the prior versions have failed? The IDPA includes two key provisions that were not included in prior versions and which limit the damages recoverable under the IDPA for an infringement. These additions may prove instrumental in whether or not this legislation passes.

First, the legislation requires that before any infringement complaint is brought, the owner of the protected design must provide the alleged infringer with written notice of the alleged infringement. While the specifics of what must be included in that notice are enumerated in the IDPA, more significantly, the proposed legislation precludes a plaintiff from filing an infringement lawsuit relating to a fashion design until twenty-one days after the aforementioned notice is provided.

The second significant addition to the current version of the IDPA is the measure of damages a claimant can recover following an infringement. The proposed legislation provides that an infringer will only be liable for damages and profits accrued after the date on which the action for infringement is commenced. When read together with the notice requirements, the new legislation provides for the functional equivalent of a safe-harbor, insofar as an alleged infringer may be able to shield itself from a damage award by ceasing to sell all allegedly infringing pieces upon receipt of the required twenty-one day notice.

IV. Conclusion

It is presently unclear whether the IDPA will succeed where its predecessors have failed. A number of the provisions of the proposed legislation represent a significant expansion of copyright protection to items that are not protectable under current law. While other aspects of the IDPA could significantly alter its practical effect, it will be interesting to see how the IDPA is modified, if at all, as it moves its way through the legislative process and whether it garners wide support.

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Fashion Companies: A Step-By-Step Guide to Protection

Farah P. Bhatti and Jessie K. Reider

Protecting the Brand
In fashion, a company's brand, or its trademark, is the most important part of the company's image. Companies need to take branding very seriously because the clothing itself doesn't have as much meaning without the brand that is attached to it. This protection is the easiest, and often the only, intellectual property protection available for clothing companies.

Protecting the Copyright
Copyright protection is often not available for apparel companies' primary products—clothing. The design of clothing is considered functional and generally does not fall under the copyright protection laws. The copyright laws protect the way that an idea is put into a tangible form, which means that apparel companies can sometimes protect drawings or other physical representations of their designs, but they cannot get protection solely for the actual design of the garment.

A graphic or logo used on a t-shirt is often considered separable from the garment, which means that the design or logo on the shirt is protectable. Similarly, the design used on fabrics—florals, plaids or other designs—are protectable. Jewelry can be protected, but it has to be unique and nonfunctional for protection to apply. A belt buckle that can be removed from the belt with the belt still working may be considered ornamental and nonfunctional, and therefore, protectable.

Patent Options for Apparel Companies

- Utility
- Business Method
- Design

Utility Utility patents may be available to apparel companies. Utility patents cover items that are functional, and in some cases, clothing designs may be functional. For example, creating a nontear material for motorcycle jackets so that the fabric does not tear when someone falls may be eligible for utility patent protection for the way the fabric is woven or made.

Business Method A business method patent is an option for some apparel companies. For instance, if a company comes up with a new way to sell a product online, that process may be eligible for a business method patent. While business method patents may prove to be worthwhile, recent court cases have muddied the waters with regard to the strength of the protection, and the patent that issues may not be enforecable against third parties.

Design Patent Another option is a design patent. For example, Crocs has a patent on the look of its shoes, which is fairly common among shoe companies. However, since it can take a very long time for a patent to issue, obtaining a design patent for a design that is not on the market for more than one season, may be useless, as the style may be off the market before a patent ever issues.

Nonetheless, patents are very useful for companies such as shoe wear and accessory companies that do not anticipate a major change to the design of their product over a three- to five-year, or even longer, period of time. This tool is useful against third parties that may be using something that is colorably similar to a product that has already been patented.

Trade Dress
Another type of protection is trade dress. Trade dress can protect the look of a retail store or boutique that a company may be setting up. There is also protection available for product packaging or configuration. A perfume bottle may be protectable if the look of the bottle is unique, for example. More and more, clothing companies are relying on trade dress to protect innovative designs, from the shape of a shoe heel to the design of a hand bag.

Selecting A Brand
Companies need to create a brand that is unique to the company and will identify the source of products. It's also important to select a trademark that will leave a positive impression with the consumer, rather than something that people will view negatively or that leaves them unsure of the nature of the product.

Another important element in creating a brand is ensuring that the new mark won't infringe on someone else's rights. The mark cannot be identical, obviously, but it also cannot be similar enough that it will be confusing to consumers with regard to an existing mark. If a company elects not to proceed with a trademark-availability search, it can end up with a cease-and-desist order after the products have entered the marketplace. It's possible to end up with a large amount of inventory that would have to be re-labeled in order to be sold. In some cases, there may also be liability for damages if substantial sales of the products bearing the infringing mark were already sold.

Biggest Hurdles
Fashion companies often have one primary brand that they use on everything they produce, but they may create an item with a seasonal or temporary name or brand. Sometimes it's not clear how long that name or band will be used, especially if the trademark is not the primary brand. The biggest decision here is how to know whether a brand or line name should be protected when the time frame for use is unknown. For company owners who imagine a product being one that can return for several years, a trademark filing can be useful, but for something that the company envisions marketing for a single season, a trademark filing may not be worth pursuing given the cost and length of time it takes to register a mark.

Securing trademark protection is not enough to protect a brand. A brand owner bears the burden of policing its mark and searching for people who are infringing the mark. Not being proactive in checking for infringers will give the false impression that the trademark owner is not all that interested in protecting its mark. In some cases, the trademark owner can lose its mark if it never pursues enforcement against third-party uses of the mark.

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Strategic Licensing Considerations

Vicki Dallas

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From the View Point of the Licensor

Brand Identity

First and foremost, a licensor must evaluate whether a strategic licensing arrangement will enhance and improve the licensor's brand. A licensor should have a design philosophy and creative vision in place in order to keep the brand identity intact. It is also important to understand and limit the time commitments that will be involved from a creative and management point of view for the licensor. Performance metrics should be addressed and incorporated into the agreement to ensure performance goals are met by the licensee.

The licensor also needs to evaluate whether the licensee has the financial strength to perform its obligations to promote the identity of the brand in a manner that will satisfy the objectives of the licensor. Other key issues to address include: which products and trademarks are covered, the royalty arrangements and design fees, whether the arrangement is exclusive or nonexclusive, the definition of the design and approval relationships relating to the products and product promotions, and the term and termination of the license agreement. The licensor will also need to retain rights to police the quality control of any licensed products to ensure brand integrity. Other licensor considerations include retaining approvals over manufacturing, distribution channels, and advertising and promotion programs.

License Grant

The initial step is to define the products and trademarks to be covered and the rights to be granted in the license agreement. A licensor can control the scope of the license by including and excluding certain products and trademarks, incorporating exclusivity and territorial restrictions, and limiting assignment and sublicensing arrangements.

Royalties and Other Payments

Most licensing arrangements include initial up-front payments that are generally nonrefundable license fees, used to compensate the licensor for the costs of investigating the licensee and covering documentation costs, and which may or may not be creditable to future royalties. The main source of revenue for the licensor is a royalty fee, and this fee may be fixed or varied based on a percentage of sales or other factors. Royalties are typically structured with minimum payments to ensure that the licensor will have a reliable royalty stream.

Royalties based on gross sales or net sales are generally favored by both licensors and licensees. From the licensor's point of view, gross sales and net sales are harder to manipulate (in contrast to royalties based on net profits which may be manipulated by the licensee often leading to litigation), and from the licensee's point of view, the licensee can avoid disclosing profit information to the licensor. Another method of calculating royalties is to use gross profit, whereby the cost of goods sold is subtracted from gross sales, which generally includes directly allocable expenses, such as manufacturing expenses, raw material costs, and direct labor costs. An advantage of this method for the licensor is that the licensor can take advantage of increasing profit margins. Another royalty option is to use a flat per unit royalty on products sold.

The license agreement may also contain advertising and promotion payment minimums. In all cases, the licensor will need to retain audit rights to verify the accuracy of the licensee's accounting for royalties and other financial obligations.

Term and Termination

The duration of the license, any renewal provisions, and the termination provisions need to be clearly set forth in the license agreement. A licensee will generally want a longer term if a substantial start-up investment is involved. This is often balanced by the licensor with a minimum sales requirement to ensure that the licensee will be actively marketing the licensed products.

Clearly defined termination provisions need to be included. As is the case in other agreements, the parties should be able to terminate the license agreement upon the occurrence of a material breach. The termination provisions should instruct the parties on what occurs upon termination, and should address the return of all proprietary materials to the licensor. The licensor will want to reserve the right to terminate the license if the licensee is not performing to the minimum performance thresholds.

Key Takeaways

Strategic licensing is an important way for an owner of a brand to increase profit and diversify revenue streams. A licensor can exploit its brand presence by expanding into new product categories, gaining access to new technology, resources, markets and geographic areas. A well thought out written license agreement, which aligns the business interests of the licensor and licensee, is a key tool in implementing a successful strategic licensing plan.

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To Improve or Not to Improve? Pre-Disposition Preparation and Processing of Collateral

Anthony R. Callobre and Harold J. Lee

Does a secured party have a duty to improve collateral prior to disposition? Section 9-610(a) of the Uniform Commercial Code (the "UCC") states that a secured party after default may dispose of collateral "in its present condition or following any commercially reasonable preparation or processing." This provision suggests that a secured creditor, after default, has the option to dispose of collateral without any preparation or processing. But the official comments to Section 9-610 and the prevailing case law tell a different story. A secured party might have a duty to improve collateral prior to disposition.

Commercial Reasonableness

Comment 4 to Section 9-610 of the Uniform Commercial Code states that a secured party does not have the right to dispose of collateral '"in its then condition' under all circumstances." Specifically, Comment 4 provides that "[a] secured party may not dispose of collateral 'in its then condition' when, taking into account the costs and probable benefits of preparation or processing and the fact that the secured party would be advancing the costs at its risk, it would be commercially unreasonable to dispose of the collateral in that condition."

What constitutes commercial reasonableness in the disposition of collateral is not addressed in the UCC. The case law provides some context, but the conduct required of a secured party is ambiguous. A general rule of thumb has developed under UCC lore: a secured creditor intending to dispose of a car on default should wash the car, but probably should not overhaul its engine. This crude example is clear enough, but between the extremes of washing a car and overhauling its engine lies an immense middle ground where the duties of a secured party are not so clear.

Cost Benefit Analysis

Most cases suggest that a secured party should employ a cost-benefit analysis in determining whether to prepare or process collateral before disposition. Most courts have held that a secured party must weigh the anticipated costs and probable benefits of improving collateral. The secured party must evaluate whether the benefit from improving the collateral would exceed the cost of improving the collateral.

The secured party generally is required to improve collateral if the expense and effort of preparation is small compared to the benefit of such improvement.[1] If a better price cannot be obtained after the repair than if the repair had not been undertaken, the preparation of collateral is not commercially reasonable.[2] And where the cost of improving the collateral is uncertain or expensive, or burdensome or extensive, such effort by the secured party is not required.[3]

Custom in the industry is also a factor. For example, one court held that dismantling, cleaning and painting an oil rig before sale was a usual practice for oil rig collateral and that it therefore was commercially reasonable to expect the secured party to perform these acts before disposing of the collateral.[4]

Work in Progress and Raw Materials

A particularly vexing issue is whether a secured party must complete production of work in process or upgrade raw materials. A debtor might argue its secured party should complete work-in-process inventory to create more marketable and valuable finished goods. A debtor might also claim that its secured party should process the debtor's raw materials to increase their value, even if a ready market exists for the sale of those raw materials in their existing form.

There is little case law to guide a secured party with respect to raw materials and work in process. Nevertheless, since most cases suggest that only superficial repairs or clean-up are necessary, courts probably should not require a secured party to make significant improvements to repossessed raw material or work-in-process inventory.[5]

Agreement on Disposition Mechanics

The debtor and secured party may agree in advance upon appropriate disposition mechanics. Section 9603(a) of the UCC allows the secured party and the debtor to agree upon the method of disposition and the degree of preparation and processing of the collateral that will be deemed to be commercially reasonable. Courts will respect such agreement if the disposition standards are not "manifestly unreasonable."[6]

Conclusion

Comment 4 to Section 9-610 of the UCC advises that courts "should not be quick to impose a duty of preparation or processing on the secured party." Nevertheless, a secured party must prepare the collateral for sale in at least some circumstances. What constitutes "commercially reasonable" conduct by the secured party in preparing collateral for disposition is ultimately a factual question that requires a cost-benefit analysis. The secured party must conduct this analysis carefully. Failure to meet the obligation of commercial reasonableness impairs the secured party's right to collect a deficiency judgment against the debtor,[7] and the debtor may not waive the secured party's obligation of commercial reasonableness in the disposition of collateral.[8] The secured party and the debtor may, however, agree in advance on the method of disposition and the type of preparation and processing of collateral. So long as these arrangements constitute a voluntary agreement by the debtor, rather than a waiver by the debtor of the secured party's duty of commercial reasonableness, they should be enforceable.

1 Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code, v. 1 (Third Edition).
2 *Richardson Ford Sales, Inc. v. Johnson*, 676 P.2d 1344 (N.M. Ct. App. 1984).
3 See *Whitney Nat'l Bank v. Air Ambulance By B & C Flight Mgt., Inc.*, 516 F.Supp.2d 802 (S.D. Tex. 2007).
4 *Liberty Nat. Bank & Trust Co. of Okla. City v. Acme Tool Div. of Rucker Co.*, 540 F.2d 1375 (10th Cir. 1976).
5 Clark, 4-111.
6 Rev. UCC § 9603(a).
7 Rev. U.C.C. § 9-607(c); Rev. U.C.C. § 9-626(a)(3)
8 Rev. U.C.C. § 9-602(7)

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period significantly longer than the traditional time (21 years after the death of the last member in a named class of then living individuals) or even continue in perpetuity with no required termination. Establishing a Dynasty Trust in Arizona potentially enables three or more generations to enjoy the use and enjoyment of these assets without any Estate Tax consequences at any level, and may afford major asset protection.

3. Qualified Personal Residence Trusts ("QPRT")
A Qualified Personal Residence Trust is designed to be a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust, but retains the right to live rent-free in the residence for a specified number of years. At the end of that period, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries for a fair rental rate if he or she wishes to remain in the house. Additionally, during the term of the QPRT, as trustee of the QPRT, the owner will always have the control and decision-making authority as to whether to sell the residence in the future in exchange for another residence or otherwise.

The tax advantage of the QPRT comes primarily from the way in which the value of the residence is calculated for Gift Tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather the gift is valued based on the beneficiaries' right to receive the residence only after the specified number of years. The value is calculated based on a number of factors including the age of the donor, the number of years the donor can remain in the house rent-free, the value of the residence at the time of the gift and the IRS prescribed discount rate required for the calculation. A higher IRS discount rate produces a lower gift tax value. Although the IRS rates have been at historic lows, suppressed property values may still produce favorable outcomes. Additionally, for clients over age 65, a low IRS rate has less of an impact on the Gift Tax value.

However, no matter how a QPRT is structured to reduce the gift, the gift will still be substantial. With the increased gift exemptions ($5,000,000), QPRTs may be an appropriate gifting opportunity for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption on such a gift but now find themselves with "extra" exemption to spare.

4. Grantor Retained Annuity Trusts ("GRAT")
Because of low interest rates, the use of Grantor Retained Annuity Trusts, has become very popular. GRATs allow you to transfer certain assets to your beneficiaries at a discounted gift tax value. This is because you retain the right to receive payments from the GRAT for a certain number of years before the GRAT terminates in favor of your beneficiaries. The amount of the payments you can receive can be calculated so that you will be deemed to have made a "zero gift" upon funding of the GRAT. With the increased gift exemptions, clients may design a GRAT with a relatively low annual payment, while using the gift tax exemption to cover the value of the remainder interest for your beneficiaries and avoid gift tax.

In essence, the GRAT works similarly to the QPRT in that the client makes a gift of a family asset (in this case either marketable securities, bank accounts, or income producing real estate) to a trust for the benefit of their children rather than in the case of a QPRT where you make a gift of your primary residence or a vacation home. Similar to your ability to remain in your residence for specified period of time in the case of the QPRT, with the GRAT you will be able to enjoy much of the income that is produced from the investment securities, bank deposits and/or real estate so that your lifestyle cash flow needs will not be impacted. However, the good news is that at your death the appreciated value of those assets gifted to the GRAT will pass tax free to your heirs. During the GRAT term, as trustee of the GRAT, the client will maintain the investment decision-making authority and can sell the underlying securities for other investments.

In sum, as of the date of this alert we do not yet know what Congress will do with regard to the tax law for 2013 and beyond, but there is a strong likelihood that the exemptions for Gift and/or Estate Tax will either drop significantly as mentioned above or certainly be reduced; and, therefore the use of the Gift Tax Exemption is a **use it in 2012 or lose it** scenario.

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