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IP Due Diligence in M&A Transactions

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In the current competitive environment, companies often seek to grow their businesses or enter markets through acquisition; particularly the acquisition of businesses with intellectual property (IP) and/or technology. As a result, more and more mergers and acquisitions involve IP. This is especially true when a transaction involves a privately held company in the technology sector for which IP may be perceived as adding value to the business.

Due diligence is the legal process that buyers and sellers engage in to identify, investigate and evaluate a target company's business and assets, including, IP assets. Effective due diligence allows buyers and sellers to identify the IP involved and evaluate the scope and importance of such IP to the transaction. Due diligence also allows buyers and sellers to evaluate possible IP risks and to address those risks before closing either through curing, mitigation and/or negotiation of appropriate representations, warranties and indemnifications. Proper investigation and evaluation of the IP assets to be acquired in a deal can be the difference between a successful transaction and an unsuccessful one. Discussed below are general considerations, key pitfalls/potential deal-breakers and the mitigation of issues found during the due diligence process.

General Considerations

Most transactions will involve the negotiation of a Non-Disclosure Agreement (NDA). From the buyer's perspective, the NDA should be very specific in content and limited to a short period of time to avoid burdensome, long-term obligations of confidentiality. A seller, on the other hand, will want to negotiate an NDA that is relatively broad in terms of coverage and time period.

In a potential acquisition, the seller typically identifies the U.S. and foreign IP and/or technology. If the IP rights are important to the deal, the buyer should investigate and evaluate those IP rights, thoroughly. The depth of the investigatory dive is typically tied to the importance of the IP to the transaction. A thorough due diligence evaluates patents, trademarks/service marks, trade secrets, copyrights, IP Licenses and any other agreements involving IP. All past litigation and the outcome of such litigation, and all current litigation or threatened litigation related to the IP assets or technology should be reviewed and evaluated to determine the potential impact on the proposed conduct of the acquired business by the buyer.

Pitfalls & Deal Breakers

Each deal is different, but the following are key pitfalls and potential deal-breakers that may be uncovered during due diligence.

1. Chain of Title Issues

The most common pitfalls uncovered during due diligence are chain of title issues for one or more IP assets. This may occur when IP assets have been previously acquired from a third party and title has not been updated for the new owner, or title to the IP assets has not been updated for corporate name changes or lien releases. Sometimes, a seller may not actually own the rights to, or *all* of the rights to, certain IP assets that the seller represents it owns. This can happen when there has been a failure to obtain all of the appropriate assignments for patents or technology developed by consultants, contractors or employees. When there is a duty, either contractually or under law, to assign, chain of title issues can typically be cured fairly easily. When there is no duty to assign, the buyer may want to require that the seller obtain, at its expense, all of the rights to the IP asset prior to the transaction closing.

2. Key IP is Jointly Owned with a Third Party that has no Obligation to Assign

In the context of technology-based IP assets, jointly owned IP frequently results from a "collaborative arrangement" with a customer to improve an existing product, or with a consultant or contractor to improve or create a new product. Usually, a company that collaborates with a customer, consultant or contractor will ensure that the company owns any inventions or technology that results from the arrangement. Sometimes that does not happen and joint ownership results.

While it often sounds "fair" that the invention should be "jointly owned" by the company and the customer/consultant/contractor involved, joint ownership has the potential to create business and enforcement challenges. For example, under U.S. Patent Law, a joint owner that makes, uses, sells, imports or licenses the invention covered by the jointly owned patent is not required to share any money received from doing so with the other joint owner(s) of the patent. In a scenario in which the seller and a third party are joint owners of a U.S. Patent, a potential buyer should keep in mind that the third-party may operate as a competitor and/or is free to license the jointly owned patent to a competitor. In addition, enforcement of a jointly owned U.S. Patent typically requires each joint owner to be joined in the suit against the alleged infringer. This means that enforcement may be very difficult. Thus, depending on the importance of the technology, joint ownership of IP that is key to the conduct of the current or future business may be a deal-breaker if the seller cannot obtain *all* of the rights to the IP *prior to* close of the deal.

3. Missing IP

Once in a while key IP is not included in the deal either through accident or otherwise. The best illustration of this is the well-known cautionary tale regarding the acquisition of Rolls-Royce Motor Cars Ltd. by Volkswagen Group (VW).

In the late 1990's, Vickers PLC (the parent company) offered Rolls-Royce Motor Cars Ltd. for sale. Rolls-Royce Motor Cars Ltd. produced luxury cars under the Rolls-Royce and Bentley brands. Both BMW and VW were interested with VW eventually outbidding BMW and paying between $700–800 million for Rolls-Royce Motor Cars Ltd.

After the deal closed, it was discovered that while VW had acquired the luxury automaker's former workforce, factory, equipment and designs, VW had not acquired the right to use the Rolls-Royce name and logo. It turned out that Rolls-Royce PLC (a separate aircraft engine division) actually owned the marks and had been licensing them to the automaker Rolls-Royce Motor Cars Ltd. Furthermore, the license agreement stipulated that Rolls-Royce PLC would retain certain marks, including the Rolls-Royce name and logo, if the automaker, Rolls-Royce Motor Cars Ltd., was sold to a foreign owner. To make matters worse, Rolls-Royce PLC (the aircraft engine division), then licensed those desirable marks to BMW, *not* VW.

One of the due diligence lessons that may be distilled from this unfortunate tale is the importance of verifying that the buyer will acquire *all* of the IP assets, or the rights to use those IP assets, that relate to the seller's business as it is presently conducted and as the buyer plans to conduct it in the future.

4. Onerous IP Clauses in Unexpected Places

We expect IP ownership clauses to be in certain agreements such as development agreements, consulting agreements, confidentiality agreements, and the like. However, sometimes IP ownership clauses can be hidden in agreements that we do not expect. For example, IP ownership clauses can occasionally be found in purchasing/distribution agreements for services and products (even in agreements for products that are off-the-shelf products). Sometimes such clauses may, under certain conditions, transfer the rights to improvements in products/services to the customer and give the customer a non-exclusive license to the underlying technology for so long as the customer utilizes the improved product/service. The resulting obligations of such entanglements can be onerous and a prospective buyer may not want to assume them, especially if future growth plans include development of improvements to the products/services that are subject to the agreement.

5. Government Funding Rights

When inventions are funded either entirely or partially by the U.S. Federal Government (often the case in inventions developed by a university), the U.S. Federal Government has a nonexclusive, irrevocable, paid-up license to practice, or have practiced for or on behalf of the United States, the patent that covers the invention. In addition, under the Bayh-Dole Act, the funding agreement typically includes a Preference for U.S. Industry clause. In short, this clause precludes a receiver of the government funds or an assignee from granting the exclusive right to use or sell in the U.S. any invention covered by the patent unless the products embodying the invention or produced through use of the invention are manufactured substantially in the U.S. A waiver from the Federal funding agency may be granted upon showing that (a) reasonable but unsuccessful efforts have been made to grant licenses on similar terms to potential licensees that would be likely to manufacture in the U.S. or (b) that under the circumstances domestic manufacture is not commercially feasible. These waivers take time and documentation to obtain. This can be a deal breaker if a prospective buyer's business plan is to manufacture products covered by such a patent outside of the U.S. and then to sell the products in the U.S.

6. Assignment and Change of Control Issues

An anti-assignment clause in an IP license or other important IP agreement that precludes all assignments can be a deal breaker when the subject IP is important to the buyer. Similar clauses that either restrict assignment (e.g., no assignment to a competitor) or condition assignment (e.g., based on approval) can also pose problems. Some such clauses state that a change of control is considered an assignment. Termination clauses in agreements should also be reviewed as some allow a "non-assigning party" to terminate an agreement in the event of a non-permitted assignment, or that the agreement automatically terminates upon such a transfer. In general, buyer and seller should pay close attention to whether consent to assign is required and when a notice of the assignment should be given to a third party. There may not only be contractual requirements but also strategic considerations, as the seller or buyer may not want a third party to be aware of the potential acquisition until absolutely necessary.

7. Patent Scope is Narrow or Does Not Cover Key Products

The claims of a patent define the scope of coverage of the patent. Sometimes an analysis of the patent(s) to be acquired indicates that the patent claims do not cover the key commercialized products that they were initially intended to cover, or can be easily designed around by a competitor to evade coverage.

To obtain a granted patent, typically there is a back-and-forth negotiation between the applicant and a patent office examiner regarding the novelty/non-obviousness of the claims in relation to the teachings and inventions disclosed in prior art (e.g., other patents, patent applications, printed publications, etc.). Claim scope may be narrowed by written amendments to the claim language as well as by written arguments made to the examiner that characterize the scope or the interpretation of the claim language. While the claims of a patent application may start out with broad scope that covers the planned commercial embodiments, the applicant may have to narrow the scope to obtain a patent. Sometimes, the narrowed claims no longer cover the key commercialized product(s).

Occasionally, an underlying issue is that the claims of the issued patent are actually directed to a product envisioned early in the development cycle and are not directed to the final commercialized product. This can occur when the early product turns out to be difficult or expensive to manufacture and an alternative design is commercialized instead.

When the granted patent(s) do not exclude others from making the commercialized embodiments (or practicing the commercialized method), buyers should consider the impact on their business plan and reevaluate the value of such patent(s) to the transaction.

8. Limitations on Use or Expansion of a Trademark, or Registered Trademarks do not Cover Key Goods/Services

Sometimes trademarks/service marks may be subject to concurrent use agreements or other agreements that limit rights. A concurrent use agreement is an agreement on how two parties will use a mark. Such an agreement can include detailed geographic divisions. It may, for example, allow one party to own the right to use a mark within a defined area around certain selected cities, while the other party owns the right to use the same mark everywhere else. This can be a deal-breaker if the buyer's anticipated business plan relies on the expansion of the branded product/service outside of the agreed geographic area.

Agreements that restrict a trademark/service mark owner from expansion into goods or services other than those for which their mark is currently registered can also be deal breakers, depending on the buyer's anticipated business plan for the branded product/service. These agreements are generally enforceable and therefore should be carefully considered. For example, when the Clorox Company purchased the PINE-SOL trademark and related business from American Cyanamid in 1990, Clorox planned to grow the acquired business by leveraging the strength of the PINE-SOL mark into use on additional products. However, the mark was purchased subject to a prior 1987 agreement that American Cyanamid had entered into with the owner of the LYSOL trademark to settle various ongoing disputes. The prior agreement limited use of the PINE-SOL mark to "all-purpose, generic cleaners," thus restricting American Cyanamid (and subsequently Clorox) from expanding the use of the mark to other goods. Clorox tried to void the terms of the agreement through litigation but was unsuccessful.

Yet another pitfall can occur when trademarks used on key commercialized goods are not registered for use in connection with those goods. If that is the case, a buyer should verify that the mark is still available for registration for use with those key products.

9. Patents/Trademarks Have Been Abandoned, Lapsed or Expired

Typically this occurs when either maintenance fees/annuities have not been paid or other deadlines have been missed at patent and trademark offices. Sometimes this can actually occur during the due diligence period itself. Buyers should verify the schedule of upcoming deadlines for each IP asset with respect to fees to be paid or office action responses to be filed and require a seller to maintain all of the IP assets up to closing.

10. The Trade Secret May No Longer Be A Secret

A trade secret may include formulas, patterns, compilations, programs, devices, methods, techniques or processes. The trade secret must have actual/potential economic benefit and must be the subject of reasonable efforts to maintain its secrecy.

Trade secrets are often quite valuable because they can be enforced for as long as they are maintained as a secret and have economic benefit. The recipe for Coca-Cola is a famous example of one of the most valuable trade secrets in the world. The precautions that the company takes to guard it are legendary and include pulling operations out of an entire country to avoid government required disclosure of the recipe.

The pitfall most typically encountered during due diligence is that a seller has little documentation of procedures implemented to maintain the secrecy of a trade secret, or no longer follows those procedures. This raises a concern for a buyer as to whether a court will protect the trade secret. For example, a court may not find the trade secret protectable if employees that practice the trade secret are unaware that it is a trade secret and have not signed an agreement with confidentiality provisions that cover the trade secret. Buyers should be wary when there are few documented or demonstratable procedures in place to maintain the secrecy of the trade secret or if the actual/potential economic benefit is very hard to quantify.

11. Key Patent/Trademark Applications are too Early in the Prosecution Process to Determine Scope with any Degree of Certainty

When first filed, the claims of a patent application may be relatively broad in an attempt to obtain the broadest reasonable coverage. However, most claims are narrowed—sometimes significantly narrowed during prosecution. Thus, the scope of potential patent coverage is usually not able to be determined with certainty early in the prosecution process. A buyer should be reasonably cautious when evaluating such early stage patent applications.

Similarly for trademark applications, the goods and services for which a trademark/service mark has been filed may need to be narrowed during prosecution to obtain a registration. A buyer should be reasonably cautious and review any trademark searches and the prosecution history at the respective trademark office when evaluating the likelihood of registration.

12. Terminal Disclaimers

In the U.S. there is a judicial prohibition against patenting obvious variations. Terminal disclaimers are sometimes filed in a pending patent application to overcome a non-statutory double patenting rejection. When a terminal disclaimer is filed, the applicant states that the subsequently issuing patent will have the same term as a previously issued patent AND that both patents will be commonly owned. The pitfall that can occur is that, if at any point in time, both patents are not commonly owned, the patent(s) subject to the disclaimer become(s) unenforceable. Thus, if one or more patents subject to a terminal disclaimer are to be acquired in a transaction, all of the patents linked by the terminal disclaimer should be acquired because the patents subject to the disclaimer become unenforceable when common ownership ceases.

Resolution and Mitigation of Risks

In every deal there are risks. Representations and warranties, indemnifications, exclusions, disclaimers, caps and thresholds are heavily negotiated tools that help mitigate risk related to IP assets.

Representations & Warranties – Buyer's Perspective

A buyer wants clear and definite representations and warranties with regard to the definition of IP, the seller’s ownership, infringement of seller’s IP and non-infringement of third parties’ IP.

As illustrated by the Rolls-Royce Motor Cars acquisition by VW, a buyer will always want to ensure that there is no IP missing from the deal relating to conduct of the acquired business, and that the IP Schedule describes all rights relating to the acquired business which have been licensed to third parties and rights licensed from third parties. It is typical to also require a representation from the seller that the seller owns *all* of the rights to the IP transferred.

To avoid unpleasant surprises, a buyer will also likely negotiate for a representation from the seller that no claim by any third party has been made, is currently outstanding or is threatened that contests the validity, enforceability, use or ownership of the IP. Similarly, to guard against stepping into a brewing dispute that may not have been disclosed during the due diligence, a buyer may seek a representation that the seller has not received notice of, and is not aware of, any facts that indicate a likelihood of any infringement or misappropriation by, or conflict with, any third party, and that seller has not infringed, misappropriated or otherwise conflicted with any rights of any third parties. Even if there is at present no anticipated potential litigation related to the IP assets, a buyer will often want to obtain "further assurances" that the seller will provide assistance in any enforcement action and in defensive litigation related to the IP assets.

The buyer may also seek to obtain seller's continued confidentiality of transferred and shared information related to the IP assets and enforcement/defense of the transferred IP rights. In addition, a buyer typically wants to obtain assurances that: (a) the chain of title of each IP right transferred is "clean" at the time seller assigns such right to buyer, (b) such assignment is not in violation of any other agreement, and (c) the seller will provide assistance, as needed, so that the buyer can update the chain of title after closing. To avoid abandonment of an IP asset during the due diligence, the buyer will typically require a representation from seller that the seller maintained the IP rights up to closing.

Representations & Warranties – Seller's Perspective

Simply put, a seller will want to limit representations and warranties (especially with regard to ownership, third-party claims, infringement or misappropriation) with qualifying language and with exceptions to the IP Schedule so that the representations and warranties are reasonable and can reliably be made. Occasionally, a buyer will request a representation related to use of the IP assets in the acquired business as that business is proposed to be conducted by the buyer. Sellers should try to avoid having to make such a representation.

Indemnifications – Buyer's Perspective

The buyer will want indemnification for breaches of representations and warranties, and for known claims (including patent litigation), and sometimes for future claims related to IP. Often the buyer will want to negotiate a longer survival period for IP claims than the survival period for general representations and warranties, and, if there is current litigation, may want to negotiate a special indemnity or escrow of money if there is risk of a substantial judgment. A buyer may also want to control the defense and settlement of third-party claims against the acquired asset (even though the seller may be paying for the legal costs via an indemnification).

Indemnifications – Seller's Perspective

The seller will negotiate to limit indemnification, as much as possible. Various strategies exist to do this: IP assets taken as-is, use of money deductibles, thresholds and/or indemnification caps, or caps on the timeframe for an indemnification event or claim. While the right to control defense of third-party claims and settlement consent can be requested for indemnified legal costs, buyers are typically adverse to such a proposal. Also, a seller typically will want to negotiate for IP indemnification to end when the survival period for general representations ends.

We can help create strategies for successful due diligence during the acquisition/sale of a business with intellectual property (IP) and/or technology. We welcome the opportunity to help you successfully navigate these transactions and mitigate any risks uncovered.

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