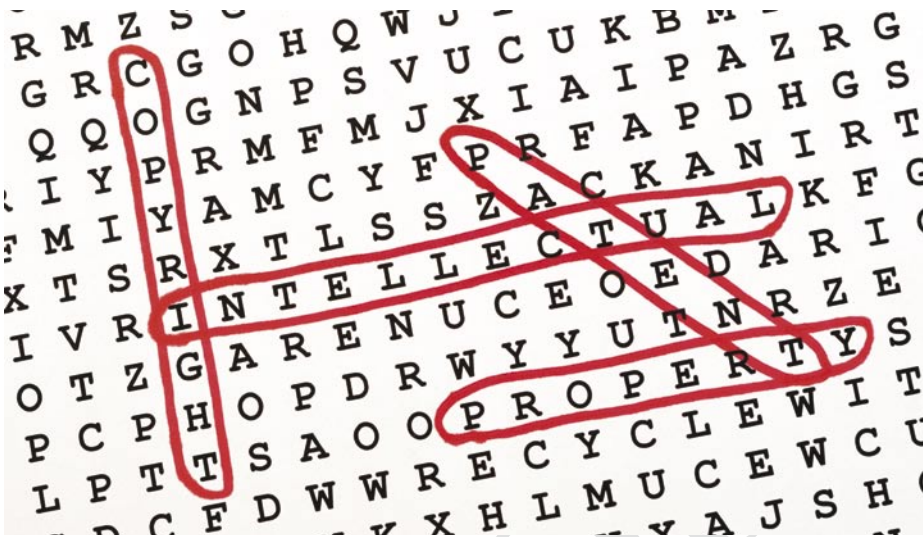


IP

Treatment of intellectual property in M&A

BY SELINA HARRISON



Thorough consideration of intellectual property (IP) issues is vital to both parties in an M&A transaction, but until fairly recently, matters regarding IP rights and licences were often overlooked or given superficial treatment. Today, it is widely accepted that the evaluation of IP portfolios, and structuring transactions to maximise opportunities and minimise risk in these areas, is essential. During the deal process, a variety of IP related issues can arise, and due diligence should include a substantive review of ownership, transfer of IP rights, IP validity and disclosure of all pending and threatened IP litigation, as well as an analysis of what IP protects which product. Once these areas are identified, legal advisers can help acquirers to assess any risk in those areas resulting from the transaction. Ultimately, due diligence needs to establish how the IP fits within the acquiring company's business plan.

Who owns what?

A number of complex IP-related legal situations can arise during M&A. "A common ownership issue that can arise during an M&A deal involves shared IP," observes Jonathan Berschadsky, a partner at Fitzpatrick, Cella, Harper & Scinto. "Meaning an IP asset that is used by the target company and another busi-

ness that is not part of the deal. Problems may arise when both parties want to have full control over such shared IP assets. Which entity will own the shared IP after closing? Is a licence to the other company necessary? If the IP involves proprietary software or processes, for example, which entity has the know how to make it run smoothly, and how will this be dealt with?" These are key issues that must be taken consideration during this process, and they will need to be resolved if the merged entity is to run smoothly.

Invention ownership is another issue that can affect the deal process. In addition to a review of domestic and foreign patents and patent applications, invention due diligence should also include invention disclosure memos and inventor publications. The acquiring company should also confirm that the acquisition target has the full rights to the IP, and there should be a clear paper trail showing all inventors who have assigned their IP rights to the company. Furthermore, any agreements licensing these rights to others should be examined because they may place restrictions on transfers under the agreement. It is also worth noting that invention ownership can also hinge on how the invention was funded, according to Scott Chambers, a partner at Patton Boggs LLP. "If,

for example, the invention was created under a federal funding or grant, the federal agency may have rights to the IP. Funding contracts can also place restrictions on the invention, such as requiring that the invention be manufactured substantially in the US if it is sold or used in the US," he says. If this is the case, the implications for the acquiring business can be quite profound. In the event that the US Department of Defense (DoD) is the company's main customer, and the funding contract gives the DoD a royalty free licence to its invention, the IP value of an invention can decline dramatically. Further, federal government contracts give the government certain march in rights and have reporting requirements for the inventing entity. If the inventing entity fails to meet the invention reporting requirements of their government contract, the entity is no longer entitled to ownership of a patent.

IP value can also decrease if a target patent has potential validity issues. For example, a court could find that references like articles and patents that pre-date the invention, called 'prior art', render a patent invalid. "For instance, presenting the invention in a conference or having an employee disclose the invention even to a friend before the patent filing can be a bar to patentability. If the attorney or inventor has engaged in 'inequitable conduct' the patent can also be declared invalid or unenforceable," notes Dr Chambers. Inequitable conduct includes actions taken before the Patent Office during the patent prosecution, such as not disclosing known prior art or knowingly misidentifying the inventors: both factors may raise a bar to enforceability. Similarly, insufficient practices to protect trade secrets may decrease the value of trade secret IP, especially if high value is placed on the know-how associated with the IP. Does the workplace have clear written policies on how to treat trade secrets? Are the employees under confidentiality agreements? Is the trade secret access limited to those who need to know? Are there locked doors, passwords, copy limitations and the like? The more tightly restricted the trade se-

crets are, the less likely they will be disclosed outside the company and the easier it will be to prove to the fact finder that the IP was a valuable trade secret. If reasonable measures are not taken to protect these trade secrets, their value is compromised.

The due diligence team should also focus on whether there is a realistic threat of third party lawsuits claiming infringement of their IP – simply having IP does not mean that the company is not infringing on the IP of someone else. The presence, absence or substance of search reports and infringement opinions must be balanced with the overall product value to the company and the risk that another party sues for infringement. Assessing freedom to operate (FTO) analysis can be the most difficult part of IP due diligence. Nevertheless, it is critical as part of the overall due diligence to clearly articulate the FTO risk involved as well as possible approaches to mitigate that risk.

Extraneous situations

Clearly, IP attorneys and acquirers need to consider many factors when conducting the due diligence process for a transaction. As such, Jeff Dodd, a partner at Andrews Kurth LLP, suggests that the IP lawyer representing an acquirer should quickly set priorities. “Of course, you need to have a firm grasp of the structure and terms of the deal itself, but you also need to work with your client to identify the crucial IP assets of the target that will require careful attention during diligence and negotiation of terms,” he says. However, sometimes, a deal

can move too fast to determine the materiality of a particular IP item or flaw. “In these circumstances, a specially crafted indemnity or holdback, requiring the target to settle pending litigation before closing, mandating consent to assignment of key licences as condition of closing, are some of the most common ways to mitigate the risk,” explains Jack Griem, a partner at Milbank, Tweed, Hadley & McCloy LLP. Of course, generally due diligence of IP rights in M&A deals is time-sensitive and challenging, even in the best of situations. But when the target company is also going through a bankruptcy process, this can be even more complex. Indeed, Mr Griem warns that one of the biggest problems in the acquisition of IP assets out of bankruptcy is that the assets have usually been neglected for some time, so their fee status and enforceability needs to be carefully checked. “For the same reason, the assets will usually not come with any representations and warranties, so an independent investigation into potential infringement and validity issues may make sense, if the acquiring company plans to make a major investment in the assets,” he adds. Dr Dodd, points out that there are pros and cons for an acquirer in this situation. “On the good side, a bankruptcy process can allow an asset sale to be made free and clear of claims, which can give the acquirer leverage and the ability to clear up some title issues in certain circumstances. However, on the bad side, the bankruptcy process can be incredibly chaotic and cumbersome and many information assets crucial to a bankrupt target’s business might not be as easily transferred as other assets of the target. For example, software licensed on a non-exclusive basis generally may not be assumed and assigned without licensor consent” he warns.

It is important for buyers to avoid a situation where IP attorneys wait on the sidelines until the structure of the deal has been initially discussed, then throw in draft IP representations, warranties and related covenants halfway through the process, or even at the end. Instead, IP attorneys should be encouraged to bring any IP issues to the buyer’s attention as soon as they are discovered. “An experienced IP practitioner will dig beneath the surface and not only uncover some of the issues described above, but also will ask questions that will elicit the bargaining power of the parties, suggest appropriate contract language, and remind the client throughout the process of any IP issues that remain outstanding,” says Mr Berschadsky. This is important – the earlier in the process that the extent of any missing information can be assessed, the sooner it can be addressed. Mr Griem advises attorneys to use unqualified

IP representations and warranties to smoke out issues that are not apparent from the documentary due diligence. “If a target company is not prepared to make an unqualified representation, there is usually a reason. Once the issue is identified, it can be dealt with either by scheduling, or by agreeing to materiality or knowledge qualifications,” he adds.

Finally, it is also useful if the IP attorneys of the acquiring company and target company collect and share the same information. To aid this process, attorneys can use IP due diligence checklists that they can find on the internet or in M&A books, although it is important that the IP practitioner does more than just fill in the blanks on these lists. “Some of the information that can be shared will include: What IP does the client own, licence or share? What IP is included in the deal? Will IP that is not included in the deal be licensed to the other party? What IP is shared, and who will own the shared IP after closing? Is anyone infringing, making threats of infringement, or challenging any IP related to the transaction?” says Mr Berschadsky.

Creating a solid structure

The structure of a transaction can have a significant impact on IP assets and how they are secured for the benefit of the acquirer. However, one common issue that hinders the structure of many deals is the lack of prioritisation of IP issues. “Corporate, tax and accounting issues often take such precedence that by the time the deal team get to the IP lawyer, the deal structure has already been set,” says Mr Dodd. There are ways to try and avoid this happening, but most importantly, both parties should have clear steps to perform during the due diligence phase, as well as regular updates on the due diligence progress. “Further, it is important that the IP lawyer of the acquiring company is attentive to the structure of the existing target. For example, if the target has an IP holding company, there could be a number of hidden tax issues, as well as potential standing and damage recovery problems that need to be addressed,” adds Mr Dodd.

It should be understood that IP due diligence is not just about reviewing publicly accessible IP information, but also target patents and applications, prosecution histories, product literature, publications containing or discussing the IP, IP licensing agreements, confidentiality agreements and material transfer agreements, invention disclosure notebooks, employee agreements and assignments, trade secret policies, in-house training procedures and documents showing trademark use in commerce. As such, both parties also need to address risks ►

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in the IP assets or integration strategies and plan how they will mitigate these risks. "Good due diligence strategies can also be used post-deal to facilitate the integration of the company IP practices and portfolios. One of the parties may have stronger trade secret protection practices that the acquiring company wants to adopt. Patent and trademark due diligence also reveals the upcoming deadlines that need to be addressed as soon as possible, helping the acquiring company hit the ground running," suggests Dr Chambers. Part of this involves tracking documents for the target company, and it is just as important that the target company state in writing when they do not have a requested item. A document invalidating a key piece of IP may destroy the purpose of the deal or trigger provisions to compensate the acquiring company if discovered after the deal is closed. Care should be taken to ensure that all people and companies with IP rights related to the acquired business assign those rights to the target company, or the

acquiring company, as a condition of closing. Counsel can then ensure that all of these people and companies assign all of their rights without any additional cost to the acquiring company.

Since the value of IP assets is dependent upon their validity and enforceability, any changes in the case law on validity or patentability standards affects all types of transactions. As such, due diligence advisers involved in the deal should be up to date on the latest case law for validity, enforceability and infringement. For example, in the US, one recent important legal development is the decision of the US Sixth Circuit Court of Appeal in *Cincom Systems, Inc. v. Novelis Corp.* "This decision held that the merger of a licensee into another company owned by the same parent company as the licensee was a breach of a copyright and software licence," says Mr Griem. "As a result of the breach, the merged companies had to pay damages substantially higher than the licence fees previously paid." He adds that the principles of

this case apply equally to an M&A transaction structured as a reverse merger, which inexperienced M&A counsel often assume will not trigger a breach of licences held by the target company. Therefore, if at all possible, licensor consent to assignment of key licences should be a condition of closing.

Another case that may impact the value of IP assets in the US is *Bilski v Doll*, 545 F.3d 943 (Fed. Cir. 2008), cert. granted, 129 S. Ct. 2735 (2009), which the US Supreme Court is currently reviewing to decide if business methods which cover processes and procedures are patentable. These types of patents are frequently used in the information technology and financial services industry, but an unfavourable opinion from the Supreme Court could invalidate these types of patents, and can potentially obliterate entire patent portfolios. For this reason, the case should be closely monitored by IP advisers. ■



Jeff C. Dodd

Partner

T: 713.220.4736

E: jeffdodd@andrewskurth.com

www.andrewskurth.com

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