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## IP Due Diligence: Look Under the Hood to Avoid Buying a Lemon

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When you buy a used car, you look under the hood to check the engine before you decide to pay, right? Intellectual property is the “engine” of many companies today. To avoid buying a lemon, it is important to look “under the hood” of the company you plan to acquire to make sure its intellectual property is in good shape, an exercise referred to as IP due diligence. It is important for a buyer to conduct IP due diligence prior to an acquisition regardless of the target company’s size or nature. Almost every company owns IP vital to its business, including its name and those of its products or services, its license agreements, its software, and trade secrets such as customer lists.

Unfortunately, even in our digital economy, intellectual property is often overlooked in a merger or acquisition deal. Such omissions can be very costly. A classic example of just how costly took place in the automotive industry. In 1998, Volkswagen was negotiating to acquire the automotive operations of Rolls Royce. VW did not perform IP due diligence. It paid £479 million for these operations, only to find that it had acquired no rights in the Rolls Royce trademark. The Rolls Royce mark and logo went to BMW, which had separately negotiated to acquire the trademark rights – and VW bought a very expensive lemon.

Clearly, IP due diligence must be performed prior to close. In fact, it is most effective to begin immediately after signing a non-disclosure agreement and before any letter of intent, agreement, or memorandum of understanding is signed to allow time to determine the level of IP due diligence the deal requires, create an audit strategy to meet deal deadlines, confirm IP ownership, and identify material defects.

The level of IP due diligence should be appropriate to the deal, considering the overall value of the deal, the importance of the IP assets,

and the buyer’s risk tolerance. The buyer’s goal should be to enter the deal fully aware of the IP assets necessary to the deal, which are being transferred, and what encumbrances, if any, are attached to the relevant ones. Once these questions are answered, the buyer can better evaluate its needs regarding the representations, warranties, indemnities, and post-closing assistance.

IP due diligence often begins with an independent evaluation of the target’s registered and unregistered assets through publicly available information. Some reports identify a companies’ registered patents, copyrights, domain names, and certain license agreements. These reports are often a starting point to verify information provided by a seller. A request for information is then sent to the seller requesting full disclosure of all intellectual property ownership interests, encumbrances on IP assets, pending lawsuits, and documents relating to IP assets. The seller’s responses are then compared against the buyer’s independent evaluation for inconsistencies. The buyer may also want to interview key employees to verify the responses provided by the seller.

The following are common scenarios arising from IP due diligence audits and how they are resolved:

1. A buyer learns that the seller does not own the copyright in, but merely licenses, key software. In such a case, the buyer should confirm that the license is assignable and that the terms of the license are acceptable or else negotiate an independent license with the owner of the copyright.
2. It emerges that the seller has not registered a key trademark the buyer intends to use after the acquisition. For

a US trademark, an assignment of common-law rights may satisfy the buyer. However, this arrangement will not work in a country that does not recognize common-law trademark rights. In such a case, the buyer should evaluate whether it will be able to use the mark without infringing third-party rights and perhaps demand a reduction in the purchase price or some other suitable concession from the seller.

3. A seller may say it owns multiple domain names. However, the administrative contact listed for the domain names is an employee of the company, meaning that the employee owns the domain name. Often, if the employee is still with the company, a change in ownership is easily arranged.
4. A seller represents ownership of certain computer programs. However, the due diligence reveals that an independent contractor drafted the source code and never assigned its rights to the seller. As a result, the seller does not actually own the software. Usually, the seller can convince the independent contractor to assign its rights prior to close.
5. A seller claims ownership of certain patents, but further investigation shows that the patents were registered in the inventor's name. Often, if the inventor is a current employee of the company, a change in ownership is easily arranged. Alternatively, the employee may have signed an employment agreement granting the company power of attorney to act on an inventor's behalf to assign the patent to the company.

While the above examples are curable, some defects cannot be easily fixed. For example, a

seller may claim it owns patents covering a product it sells. Due diligence may reveal the claims to be restricted to a few narrow aspects of the product, possibly allowing competitors to offer a competing product not including the protected embodiments. Alternatively, the patent may cover an improvement to an already existing and patented product. Without a license under the patent for the base product, the purchaser may be prevented from selling the improvement at all.

A trademark registration could be invalid even if it appears on trademark registers around the world. For example, if it is licensed to a third party and the owner does not exercise sufficient control over its use or quality of the goods it is applied to, the mark will no longer serve as a badge of origin and be susceptible to revocation. If a mark has been used in promotional materials in a generic sense so that it has become a common description for the product, the registration will be invalid. A seller may claim to have huge reputation and goodwill in a trademark by virtue of its extensive use and promotion of the mark, and seek a significant sum as its price. However, the mark may have little value if the registration is invalidated after purchase because it has fallen into generic use.

Just as important as identifying the seller's IP assets is making sure they are properly conveyed to the buyer. If not conveyed correctly, IP assets can be extinguished or have their value severely diminished. For example, an assignment that transfers a trademark without the associated goodwill may be construed to be an assignment in gross, which could subject the mark to being held invalid. Also, if a patent is assigned without a specific assignment of past damages, a buyer may be prevented from obtaining damages for pre-assignment infringements. It is thus critical that buyers have IP attorneys conduct due diligence and ensure that the transfers are handled correctly.

The cost of IP due diligence is money far better spent than costs to cure IP-related defects after a transaction has been finalized. Avoiding post-transaction nightmares is reason enough to perform detailed IP due diligence. Bottom line: look under the hood to avoid buying a lemon.