

IP Intellectual property rights in the M&A process

BY PAULINE RENAUD



The importance of intellectual property (IP) rights in M&A transactions has grown over the last few years, as they can be major value drivers in deals. With globalisation pushing at the boundaries of information distribution, most analysts expect the significance of IP assets – in the form of patentable technology, legally protectable trademarks and copyright – to increase even more in the future. Indeed, according to a recent study by mergermarket, 52 percent of the executives surveyed believe the importance of IP assets will grow substantially within the next five years, with respondents citing the increasingly “data centric world” and “greater access to information online” as key factors. But this mounting importance means that adequate due diligence and accurate asset valuations are vital for the long-term success of a transaction. As such, M&A investors must strive to identify opportunities and mitigate risks, particularly in cross-border deals.

IP due diligence

During the due diligence process, investors are advised to look at several key points. They should start by ensuring that the acquired IP and the investment thesis are aligned. This is essential to avoiding surprises, and will ensure the IP assets match a company’s core business. One could, for example, find out

that a patent does not actually cover a company’s main business, leading to a renegotiation of the transaction price. As such, an IP audit will help identify the status of patents, trademarks, copyrights and other IP to make sure they are valid and properly protected. The importance of this cannot be stressed enough. With patents and copyrights in particular, understanding whether these rights have been infringed in the past, and which action has been taken to remedy such infringement is crucial. Furthermore, the strengths and weaknesses of trademarks involved in a transaction should also be evaluated, as well as the measures taken to protect them.

A review of the target’s licences and assignments should follow. An acquiring company needs to obtain a detailed understanding of these licensing agreements, particularly concerning the scope of the rights involved and any change of control provisions that may be triggered by the deal. Such reviews will also help confirm ownership of the IP assets, explains Katherine Forrest, a partner at Cravath, Swaine & Moore LLP. “A potential transaction party should investigate whether third parties may have or claim rights in the IP. If this is the case, one must fully investigate the claims, following the entire chain of owners to find out if and how such claims may affect the use of rights,” she says. In addition, the review should help to uncover issues such

as defective ownership or ongoing litigation. All claims, be they pending, threatened or settled, must be vetted in order to reveal the vulnerabilities and potential settlements that may place restrictions on the target company, thereby influencing future decisions made by the acquiring company.

Investors should also seek to ensure that the IP is adequately secure, as failing to do so can ultimately destroy value. “The target’s privacy policies and data security procedures are often overlooked,” points out Deborah M. Lodge, a partner at Patton Boggs LLP. “However, these can be critical, especially if the target sells to consumers, collects or reviews consumer data, is a financial institution or provides services to a financial institution. While not ‘traditional’ IP, consumer data can be valuable assets.” Of course, it very much depends on the deal – during the due diligence process, the ‘one size fits all’ rule does not apply.

Different areas will be important to different companies, and investors are advised to place the emphasis firmly on what they consider to be the core IP assets, which are effectively the ‘crown jewels’ of a business. “The level of importance that companies should place on particular IP assets depends on what contribution those assets make to the overall business strategy,” says Jeremy Lowe, a partner at Axinn Veltrop & Harkrider. “Patent and trade secret assets will likely dominate technology-driven M&A, such as between pharmaceutical companies. Trademarks and goodwill will likely dominate commercially-driven M&A, such as between dotcoms. The key to any successful M&A transaction is to understand the role that IP assets play in driving the company’s profits,” he insists.

Nowhere is this more relevant than with technology companies, and a review of the licences owned by the target as well as any belonging to third parties should be a main focus during the course of a transaction. “If the target is a technology company with critical software assets, the due diligence process should include a review of the licences held by the company, assignments or ‘work for hire’ agreements, and an assessment of whether the software programs incorporate

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open source, freeware, or other third-party code that could limit the target's rights," suggests Ms Lodge. She adds that one related issue is the importance of knowing whether the target's work was funded by the government, or is subject to regulations restricting the use of the IP and granting the government licence rights. It is also advisable to look closely at trade secrets, where they are kept and which employees are critical for their preservation. Lastly, the list of domain names can also play an important role during M&A discussions. Companies should therefore investigate what rights they have in this regard and which names have already been registered.

Ultimately, the results can be dire if due diligence is overlooked. "Indeed, the obvious risk of insufficient due diligence time and resources for the examination of IP assets is that a company believes it is buying something it is not," says Ms Forrest. "It may believe it has acquired a valuable product that, it turns out, infringes someone else's patent, or that the IP itself is in fact worth much less than what was paid." A striking example is that of German carmaker Volkswagen. In 1998, the company purchased the assets of the Rolls Royce and Bentley automobiles for about \$800m. But Volkswagen did not realise until after the deal was closed that the IP assets did not include the right to use the Rolls Royce trademark. This was owned by another carmaker, BMW, pursuant to a prior agreement. Volkswagen had therefore acquired all the rights necessary to manufacture the car, but did not have the right to brand it as a Rolls Royce.

Another risk that can arise when purchasing unclear IP rights is that of being forced into lengthy and costly litigation, as was the case for Volkswagen. This not only concerns third parties, in order to protect and enforce the acquired IP rights, but also sellers, with respect to the representations and warranties given in the transaction agreement. As a result, sellers may face significant indemnification exposure as well as breach of contract claims. In order to limit such risks, it is often advised that the resources dedicated to the examination of IP assets should be proportional to the difference between the total M&A price and the value of the tangible assets purchased.

Valuing the intangible

But valuing IP assets can pose tremendous challenges, as traditional valuation methods can falter in deals wherein the IP is the main source of value. This is due to the unique qualities of IP assets and the fact that some products with IP rights may have not been brought to market yet. According to the mergermarket study on IP rights in M&A, respondents believed that IP value was not fully reflected in traditional valuation methods, such as cash flow projections. They rated exposure to patent litigation, freedom to operate and strength in key markets highest in terms of importance – but it must be conceded that these factors are not easy to incorporate into traditional valuation models.

Instead of cashflow methods, some experts recommend using real option methods, which incorporate the value associated with the uncertainty and account for the flexibility inherent in IP development. Such methods can be used in the case of acquiring a start-up with negative cashflow, or other situations involving untested IP assets. Ms Forrest adds that "another possible solution in such cases is to try to analogise to other products that include similar IP rights. For instance, with respect to a pharmaceutical product that is at the end of Phase III in the US Food and Drug Administration approval process, a look at the 'tried-and-true' path of another product for the same indication may provide a reliable IP rights valuation method, or at least enable companies to come up with a ballpark figure," she says.

Valuation can be even more difficult in certain sectors, notably media and entertainment, given the inevitable fluctuations in value. It is therefore advisable to rely on internal valuations in such cases. As far as rights for technology IP go, valuation methods will depend on whether the products covered by the rights are new, or simply an expansion of already-marketed products. In the case of the latter, companies can rely on past data, but estimates of the

valuation will be required when valuing new IP rights. Ultimately, regardless of the method used or the nature of the IP assets, a general recommendation for all sectors is to gather as much hard data as possible from similar IP rights when valuing assets.

Further risks

Companies should also consider recent changes in legislation and regulation when making an acquisition. For example, the US Sarbanes-Oxley Act has resulted in a more standardised assessment of IP rights. Also, US patents no longer grant their owner the absolute right to exclude others' trespass, explains Mr Lowe. Furthermore, these patents are likely to become increasingly difficult to obtain. "Recent years have witnessed an avalanche of patent filings, a proliferation of patent holding companies and cartels and a growing public concern that patents are stifling competition and innovation," says Mr Lowe. "Because of these pressures, the US government is poised to approve, for the first time in over 50 years, a major overhaul of the patent system." In the meantime, the growth of 'open source' and 'copyleft' programs has made the due diligence process more complicated, by further obscuring issues surrounding IP ownership and exclusivity.

IP risks are generally exacerbated in cross-border deals. Indeed, every jurisdiction has different rules regarding IP rights, so getting local advice early in the transaction process is essential. There can even be significant differences between the laws of developed regions. The EU has stricter data security restrictions than the US, for example, which can pose problems when conducting cross-border transactions between these regions. As such, the regulatory environment is often a significant variable that will determine the future strength of the IP assets. Some of the main issues that arise concern valuation, restrictions on the ownership of technology by a foreign company and data transfers. As Mr Lowe points out, "the transfer of IP assets must be recorded in the name of the acquiring company in each jurisdiction where the property exists. Also, the forum selection provisions of the acquisition agreement must account for the sophistication of the selected jurisdiction to apply cross-border laws relating to the transfer of IP assets," he adds. Tax considerations when acquiring IP assets should also be addressed, as opportunities for deductions could arise through the establishment of a holding company in a specific jurisdiction.

Of course, some regions are considered riskier than others. Developing countries such as China and Taiwan have a reputation for not enforcing IP rights as solidly as developed countries, ►►

despite notable improvements in recent years. Conducting transactions in the US and Europe can also present some challenges, as they are increasingly susceptible to antitrust scrutiny in cases where the acquisition of patents gives a company a monopoly. Furthermore, the Hart-Scott-Rodino Act in the US imposes disclosure obligations on parties in large M&A deals and requires a high duty of care when valuing the transferred IP assets. This is often compounded by the fact that IP rights are territorial, says

Ms Lodge. "A US patent confers no rights in other countries. As a result, companies that intend to expand their business internationally may find that someone else – a 'knock-off artist' or other impostor – has won the race to the trademark registry. Also, companies may find that a key invention could not be protected in a foreign country because the patent application was not timely filed or because someone else filed first," she warns.

It is clear that the ongoing evolution of the

global regulatory environment combined with the explosion of IP rights issues are making thorough due diligence on IP assets essential for an increasing percentage of transactions. This is no bad thing, in spite of the difficulties associated with IP. Indeed, if properly conducted, a clear review of an intellectual property portfolio can help an investor identify the potential risks associated with any deal and therefore try to avoid them – thereby increasing the likelihood of a successful investment. ■



Deborah Lodge
 Partner
T: +1 (202) 457 6030
E: dlodge@pattonboggs.com
www.pattonboggs.com

PATTON BOGGS LLP
www.pattonboggs.com

Deborah Lodge specializes in intellectual property, privacy and Internet law at Patton Boggs. Ms. Lodge has assisted numerous domestic and international clients with due diligence reviews and IP audits. Among her diverse clients are financial institutions, communications companies, private equity firms, publishers, e-commerce retailers, and technology pioneers. With her broad legal experience and a practical "can do" business perspective, Ms. Lodge helps clients develop and achieve their strategic goals through management of their IP assets.

In the trademark area, Ms. Lodge helps clients to create brands, market and license their

brands, and protect them from encroachment by others. In the copyright sphere, Ms. Lodge has negotiated publishing and entertainment agreements, website development agreements, and various licenses designed to commercialize clients' IP assets. She also enforces or defends clients' rights through trademark or copyright infringement litigation, domain name proceedings, Lanham Act suits, or TTAB proceedings.

Ms. Lodge also assists clients with Internet and emerging technology issues. Among her areas of expertise are privacy and data security policies, cybersquatting, and other e-business issues. She also counsels clients on

such diverse issues as advertising, publicity, sweepstakes and contests, consumer credit, and other regulatory matters. She represents clients under investigation by the Federal Trade Commission (FTC) or other consumer protection agencies.

During law school, Ms. Lodge was a member of the Boston College Law Review, where she served as Articles Editor. She is a member of the Order of the Coif and graduated magna cum laude from Boston College Law School. During 2007-2008, Ms. Lodge served as an Adjunct Professor of Copyright Law at the Columbus School of Law, Catholic University of America.