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IP due diligence in M&A transactions

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"Done badly, due diligence can lead to overvaluation of the target, exposure to unknown risks, liabilities and integration problems which could undermine synergies driving the deal."

Introduction

Generally, due diligence can be described as the process of evaluating a business situation from all aspects before making a decision. Although due diligence is often performed when buying a business, there are many other situations in which it might be performed (*e.g.,* in private equity funding through venture capitalists or while purchasing real estate). However, a due diligence cannot be seen as a general investigation, as it includes specific elements which may vary based on the situation. Although it is performed to protect both parties within the transaction, due diligence is primarily intended to protect the purchaser, especially in uncovering potential liabilities and financial matters.

This article is intended to highlight the importance of conducting an IP due diligence. The importance of IP due diligence in M&A transactions – especially in relation to the acquisition or investment in technology and biotech companies – is increasing, as the acquisition of the target's Intellectual Property Assets ("IPA"), – namely, its patents, trade secrets, trademarks and copyrights – is often the main business purpose for acquiring a company. Moreover, IPA's play a very significant role when it involves technology companies, and are important drivers for the value of a transaction. It is therefore critical that a thorough IP due diligence is carried out to ascertain the value and the validity of the IP rights being offered.

(i) **The importance of IP due diligence**

"If properly conducted, a due diligence review of an intellectual property portfolio can enable an investor to more accurately assess the inherent risk associated with an investment in a company and increase the likelihood of a successful, financially rewarding outcome"

An IP due diligence is essentially an audit to assess the quantity and the quality of IPA's by, or licensed to, the target company. It is thereby important that an assessment is made of how the IPA's are captured and protected by the target company. IP due diligence can therefore be critically important in deciding whether or not to purchase the target company or to enter into some other agreement with the target company where IP is a factor.

Generally, an IP due diligence is conducted by a purchaser in relation to the IPA's of the target company in order to obtain information about the nature and quality of the target's assets so that the purchaser can assess the risks and, in some cases, even adjust the purchase price, seek indemnification or determine not to proceed with the transaction. On the other hand, it can also be carried out by a company on its own IPA in preparation for a transaction, such as a business sale or a major licensing deal.

IP due diligence can reveal two important elements to the purchaser; (i) the quality and quantity of the IPA of a (target) company so that third parties and especially purchasers are able to put a value on them, and (ii) the chain of title from which one derives ownership of the IPA in order to ensure that one has all the necessary rights to them and whether or not any third party (is willing to) attempt(s) on infringing the IP rights (*see below*).

(ii) **Two-stage approach**

Experience taught us that M&A principals frequently devalue IP due diligence work, mostly due to the cost. Consequently, it occurs toward the end of the deal to keep the due diligence in check. This is an unfortunate consequence, as discussions with IP lawyers can easily set ground rules concerning how IP due diligence should be done and help to estimate the costs. Therefore, we suggest to performing it in two phases, whereby the IP due diligence can be stopped in the event that M&A transaction will not take place. In order to benefit from the aforementioned, it is important that parties to a transaction bring IP practitioners in an early stage to the table in order to comprehensively perform the due diligence.

Stage 1:

Stage one must be situated before the structure of the deal is decided, meaning that the purchaser must identify whether or not to structure the deal as a share purchase or as an acquisition of certain assets. Therefore, the purchaser should conduct a broad mapping of the IP assets of the target's core business in order to assess whether, and how, the core business IP is protected in order to allow the purchaser to whether it should be an asset or share purchase.

In this stage, 'high level IP mapping' must be performed, in order to determine (i) if there are any (major) obstacles to the deal, and (ii) which IPA's are core to the business of the target or the purchaser's interests. For this purpose, it is important that to start a due diligence with a thorough understanding of the purchaser's current technology position and strategic priorities, in order to determine the purchaser's technology "gaps" and strategic goals. In addition, the purchaser should make an assessment of the transferability of IPA and licenses that are granted to the company.

In the light of the aforementioned, we would like to point out that, from all the IPA's (patents, trade secrets, trade marks and designs, copyrights), patents, if present, are the most delicate M&A transactions, as they can represent the strongest challenges when it comes to post-transaction. Important is that the post-transaction challenges must – to the extent possible – be factored into the deal structure and value (*e.g.,* possible patent litigation, which is often time consuming and costly).

> *"Acquiring companies are now focusing more heavily on open source and third party code in their due diligence practices to uncover issues before M&A transactions are completed."*

Stage 2:

In stage two, the purchaser must conduct a more detailed and "traditional" due diligence. However, as it is important to understand and assess all IP assets related to products and linking revenue streams to specific IP assets, the IP due diligence should be conducted on an interdisciplinary level. In this stage and depending on the IPA, the purchasers will perform a detailed – patent, trade secret, trade mark and design or copyrights – due diligence, whereby more attention must be paid to elements such as shared IP, the chain of title of IP (ownership), legal protection of IPA and the potential use of free and open source software (see below).

(iii) **Shared IP**

The issue of shared IP can be one of the stickiest IP issues in M&A transactions. Early on, the parties with the transaction should determine whether the target and its remaining corporate group use the same IP and whether they want to continue to do so post-closing. Should that be the case, parties must:

- draft a licensing or joint ownership arrangement; or
- draft a transitional license at closing, if the seller or target only needs to use the other party's IP for a limited time after closing; or
- draft a transitional services agreement, if the seller and target are sharing software-related services and the seller and/or target will continue to provide certain programs or service to the other party (e.g., payroll or telecommunications) until it can substitute in its own services or obtain these services from a third party.

(iv) **Ownership of IPA**

It is important to find out whether the target owns the IP it purports to own. Therefore, ownership is often the first element to be investigated, as a problem with the ownership can be a deal breaker. If the ownership of IP cannot be established, the intellectual property cannot be bought or sold. Consequently, for each asset the IP due diligence must assess ownership which includes that (i) the IP registrations are up to date; (ii) a clear chain of title can be identified; (iii) assignment documents exist in the public records; (iv) there are no security issues or liens and (v) identify the right of use and control.

(v) **Legal Protection of IPA**

Most technology companies own different IPA, ranging from IP assets and designs to trademarks, copyrights, know-how and business secrets, which are included in most, if not every, product (*e.g.,* the iPhone which contains inventions that are protected under several (international) regulations). Consequently, different IPA's are protected in different ways (*e.g.,* patents, trademarks, etc., are subject to national and/or international registration, whereas copyrights are for example not subject to registration outside the US). Moreover, depending on the IPA and the applicable regulation, the scope and the length of the protection varies. The aforementioned shows that IP due diligence is a complex task that requires IP expertise.

(vi) **Free and open source software**

Free and open source software (hereinafter referred to as "FOSS") refers to programs that are developed by a company and that are made available with a source code for free[3] (*e.g.,* PHP, WordPress, Apache, Linux, etc.). The software may be modified or redistributed by those who download it, subject to various open source license terms.

FOSS raises major security concerns. The day-to-day practice of using FOSS is often uncontrolled, potentially creating unknown legal, business and operational risks arising from the unique obligations found in many open source licenses. As mentioned before, FOSS are generally made available using standard licenses, of which some are very liberal, meaning that the open source tool can be used in any way desired by the end user, and other FOSS require that any redistribution includes the release of any supplemental or modified source code.

Consequently, a thorough due diligence program, from an IP perspective, includes a review of license agreements. License agreements under which the target is the licensor are important, because they encumber the target's use of the subject IP, presumably in exchange for royalties. The most important item to look for in licenses agreements is whether, and to what extent, the target's licensed rights will be adversely effected by the transaction (*e.g.,* if the transaction is a stock purchase, provisions that terminate the agreement upon a change of control are relevant). Important to notice is that licenses of IP can appear in agreements that are not necessarily identified as "license agreements" (*e.g.,* R&D contracts, joint ventures, settlements, distribution and software development agreements, etc. also often include licenses).

As a result, acquiring companies are now focusing more heavily on open source and third party code in their due diligence practices to uncover issues before M&A transactions are completed. Hereby it is of main importance that the targeted company provides the purchaser with a list of the developed FOSS that is utilised by the targeted company and whether or not the open source component is used for internal or external purposes. If the targeted company does not provide the purchaser with the necessary information relating to the used FOSS software, the purchaser can call upon the services of specialised companies such as e.g. Black Duck, which performs – by using specialised software – audits in M&A transactions, which allows the purchaser to quickly find open source software and associated licenses and obligations in the targeted company.

Conclusion

Due diligence is an integral part of any transaction. Done badly, due diligence can lead to overvaluation of the target, exposure to unknown risks and liabilities and integration problems which could undermine synergies driving the deal. Given the financial and legal importance attached to IP, thorough due diligence on this aspect cannot be ignored or lightly dismissed. Consequently, purchaser's need to prepare for the rigours of due diligence, and have the ability to investigate the strength and enforceability of the IP in question. Finally, what is discovered during the IP due diligence process can assist in the proper valuation of a given deal. Often, it goes much further than that, as it can actually make or break the deal.

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3. Please note that not every open source software is made available free. For the sake of simplicity, we confine ourselves to software that is made available for free.