Intellectual property due diligence: front and centre at last

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Our global economy continues to challenge the business community. An ever-weakening dollar; potentially lucrative, yet unstable emerging markets; weak or non-existent intellectual property protection and enforcement efforts in significant markets; natural disasters and the ever-present threat of terrorism – the list of variables that impact investment is seemingly endless. On a parallel track, however, innovation continues unabated, relevant skill sets and inexpensive labour are available in new markets and the entrepreneurial appetite for investment remains strong. As these trends converge, we have observed a new respect for the concept of risk management and its most valuable tool – due diligence.

Conducting proper due diligence involves not only examining the financial and structural information of a company but also assessing the company’s key assets. For the vast majority of enterprises, this will necessitate a review and analysis of the intellectual property assets of the enterprise – IP due diligence. While IP due diligence will be essential in connection with an investment in virtually every type of enterprise, it may be especially significant where the enterprise is involved in the technology and/or life sciences sectors since, in such sectors, IP assets are the business.

Still, although the importance of IP due diligence in certain key IP-driven sectors of the global economy cannot be denied, our experience has demonstrated that IP due diligence should not be limited to those enterprises. Even companies engaged in traditional bricks and mortar industries own and rely upon IP assets as an integral component of their business. Examples range from the ingredients and manufacturing process for Coke, a closely guarded trade secret, to the many domestic and international trademarks owned by multinational conglomerates such as General Electric or Playboy, to manufacturing businesses where the processes utilised are patented. The process of identifying all IP assets, verifying ownership and ensuring that such assets are free of encumbrances for the intended business use is fundamental to any merger, acquisition or investment.

Properly conducted IP due diligence should provide a prospective investor with detailed information about the IP assets of an enterprise that may affect pricing or other key elements of the proposed transaction or, in certain circumstances, even recommend termination of proposed investment. As described below, the consequences of mismanaging or ignoring IP due diligence can be severe. Without the proper investigation into an entity’s IP assets, an investor may find, after the deal is already concluded, that it does not have ownership of the sought-after IP assets or that the IP assets have been transferred or encumbered by third-party interests or litigation.

A thorough understanding of this process is also essential for the enterprises themselves, since management must prepare for IP due diligence. Our firm was recently engaged by an enterprise for the specific purpose of cleaning up its extensive patent portfolio in preparation for a new round of financing. In the course of our investigation, we solidified its patent position, identified new applications and implemented an internal process for the enterprise to recognise and protect new intellectual property as it was created. The round of financing was extremely successful.
and the investor later advised all parties that the quality of the patent portfolio was central to its investment decision.

**The goals of IP due diligence**

Just as business transactions vary, the nature and scope of IP due diligence in a given deal will have their own characteristics and requirements. Among other factors, IP due diligence will be affected by the enterprise’s policies and practices related to document retention and organisation, registration procedures and the location of the IP assets, as well as the length of time in business, the maturity of the management team and the enterprise’s industry environment. As a general proposition, a start-up in business for two years after raising and burning through US$50 million on a series of transactions, employees and consultants for an array of different business initiatives, would present a very different challenge, from an IP due diligence perspective, from a well-established firm with stable legal relationships, form documents and a records library. Reality usually lies between these two extremes and, despite the discrete issues present in each transaction, the goal of IP due diligence is always the same: protecting the investors. In our experience, this is best accomplished by focusing on the following five areas:

- An initial goal of IP due diligence is to identify and locate the IP assets of the enterprise. This list may be incredibly varied depending on the nature of the business but could include patents and/or patentable subject matter, copyrights, trademarks, domain names, trade secrets, mask works, inventions, works of authorship, hardware and devices. Of course, some IP assets require closer evaluation and analysis than others due to various factors, including complexity, competition and foreign registration of IP assets.
- It is essential to determine the nature and scope of the enterprise’s claimed rights in the IP assets. The enterprise’s rights could range from outright ownership to a licence in the IP assets, with many gradations in between, including contingent rights in intellectual property to be developed in the future.
- It will be necessary to evaluate the validity of the enterprise’s rights in the IP assets. Essentially, this means making a judgement about the relative strength of rights claimed by the enterprise and, in certain instances, evaluating the nature and scope of its efforts to protect and police its IP assets. Special care should be taken to ensure that the enterprise’s actual rights comport with its representations to the potential investor, and that such rights in IP assets are sufficient to permit continued operation of the business without interruption.
- The diligence team must evaluate all potential claims of IP infringement. This exercise includes analysis of situations where: (a) the enterprise’s IP assets may infringe a third party’s rights; and (b) the enterprise has a valid (or even a colourable) claim of infringement against a third party. Either circumstance has the potential to seriously disrupt the operation of the business.
- It will be necessary to analyse any grants of IP rights made by the enterprise to third parties. This analysis would include licences, distribution agreements, reseller arrangements and any other transaction by the enterprise that involves a transfer of rights in the IP assets that may impact the value of those assets. As an example, if the enterprise had granted an exclusive licence to its primary invention for a period of five years, a business plan that contemplates issue of additional licences for the same technology would not be viable.

**Include IP experts in the due diligence team**

Prior to commencing any IP due diligence, effort should be directed to ensure that the proper team is in place. As a threshold matter, the legal team that undertakes to conduct IP due diligence must have a basic understanding of the primary product lines, business environment and future plans of the enterprise to ensure that the team remains focused primarily on the IP assets that are relevant to the business. Since the IP due diligence team will participate in the investor’s evaluation of a proposed transaction, it is also essential that the team understands the relative importance of the proposed investment to the client. Early familiarity with these issues should enable the legal team to contribute to the entire process in a meaningful way.

**Ensure that the IP due diligence plan reflects the importance of the deal**

The next step is to develop a well-drafted IP due diligence request that reflects the parameters of the deal. As an example, if an enterprise is relying on one key patent registration, then in addition to other areas it would be advisable to inquire in detail about potential competition, other patents and patent applications and steps taken to protect improvements. Questions should be designed to assist in identifying areas that merit further inquiry as evidenced by a positive response. By the same token, a negative response to certain questions permits the legal team to
Foreign laws may impact the deal

In recent years, the number of cross-border mergers and acquisitions has increased dramatically. This fact, combined with the reality that many individuals developing IP assets for American companies are from outside of the United States, increases the likelihood that IP due diligence will involve review and analysis of non-US IP assets, and/or the impact of import/export laws. When analysing such assets, it must be recalled that few countries treat intellectual property in exactly the same way and rights often depend on complex treaties and conventions executed by and among many nations. Accordingly, it will be important to avoid making assumptions about such foreign assets based upon an understanding of US laws and procedures pertaining to intellectual property.

move on to areas of genuine concern that are relevant to the business and/or the specific transaction at issue.

Take nothing on faith

Our experiences have also highlighted the importance of not taking anything on faith. Our firm recently dealt with a matter in which a client was attempting to acquire an enterprise whose main asset was a business method for processing insurance claims over the internet. As part of our efforts, patent counsel did a search on the enterprise’s business method. Not only did we find that the enterprise’s invention might be infringing another patent, we also found that there was active litigation between an entity that was holding a patent on a similar method and another company using a method similar to the one used by the enterprise. The enterprise later admitted that it had discussed this issue with other attorneys. It did not, however, disclose this in response to the IP due diligence request.

In another matter, our client was making a US$50 million investment in an enterprise holding numerous patents that were of interest to our client. As part of our IP due diligence, patent attorneys conducted a computerised search of the relevant patents. This search revealed that the ownership interests actually resided with another company. This initial computerised search was followed with a manual search. The manual search of the actual documentation revealed that the ownership interests were indeed as they were expected to be and that the computerised search was erroneous. In this case, the inaccuracy in the computerised search was the result of a clerical error in preparing the filing documents. Consider, however, the results if the opposite had occurred – that is to say, if the computerised search appeared to be accurate but was not and no further manual search was performed. This highlights the extreme importance of verifying information that is presented through more than one source.

Depending upon a number of factors, such as the nature of the responses to the request, the deal and the business, further investigative activities may include: (i) conducting searches in appropriate databases in all relevant jurisdictions to identify patent rights including pending and/or provisional patent applications, registered patents, registered copyrights and registered trademarks; (ii) examination, analysis and verification of the results of such searches; (iii) verification of claimed but unregistered intellectual property rights; (iv) review and analysis of relevant provisions of executed agreements that could include licences, consulting and confidentiality agreements, assignments and other documents; (v) interviews with key business and technology development staff at the enterprise and, where the situation warrants, with previous employees and consultants; (vi) examination and analysis of potentially infringing registrations and third-party intellectual property rights; and (vii) other efforts appropriate to the situation.

Understand the dynamic relationship between the documents and the core business

While it is extremely important to examine all agreements, registrations, filings and other documents to ensure that they are valid, the legal team must clearly establish a relationship between such documentation and the relevant IP assets. We recently represented a client that was interested in acquiring a division of an enterprise that held a large patent portfolio. Prior to the investment, the enterprise provided us with voluminous documentation purportedly pertaining to its patents (approximately 100 boxes!). However, an inspection of the documentation revealed that the information provided concerned patents that had nothing to do with the enterprise’s core business.

Resolving IP due diligence issues

The investigative stage is not likely to be the end of the IP due diligence process. This is clearly illustrated by a recent transaction in which we were involved. In this matter, a client was acquiring an internet-based enterprise. One of the main reasons for interest in this enterprise was software believed to have been developed by the enterprise. During the course of the IP due diligence, however, it was revealed that the software was actually developed by the company’s former consultants. Unfortunately, such consultants were not engaged under any type of written agreement that addressed the ownership of the IP developed by the consultants for the enterprise; neither did they ever execute any agreements assigning their interests in the software to the company. As a result, it became necessary to track down the former consultants and obtain their agreement to an assignment of their interests in the software. This is only one example of the types of issues that will often have to be addressed post-audit.

Conclusion

There is little doubt that IP due diligence has finally come into its own, recognised as an integral and important part of any investment, merger or acquisition. In order to manage risk
effectively, it is absolutely essential to obtain complete and accurate information regarding IP assets before investing any financial or human resources in an enterprise. The global nature of our economy adds an additional layer of complexity to the analysis phase of IP due diligence, requiring familiarity with and the ability to issue spot under relevant intellectual property laws of foreign jurisdictions. As always, competition for limited investment funds is and will remain intense, and an enterprise that presents with a well-developed and protected intellectual property portfolio will definitely have an advantage.

As for investors, information discovered during the IP due diligence process can assist in the proper valuation of a given deal and, more importantly, contribute leverage to the negotiation process to make or break the deal.

Specific due diligence recommendations by category of IP asset

The nature and extent of IP due diligence will depend on the type of IP rights involved. Each class of IP rights raises unique issues and will necessitate the use of different methods of review. This section presents recommendations for steps that should be taken when reviewing IP assets in each of these classes of rights. We note that while personal data is not a class of IP rights, our experience has been that it is an increasingly important part of company assets, particularly in web-driven enterprises. Since, at the same time, personal data is also subject to increasing regulatory requirements, we have also included it within our presentation of specific recommendations.

Patents
- Review all issued, pending and abandoned patent applications and patents in the United States and in foreign countries. Such review should include not only those patents currently owned by the enterprise, but also those previously owned or licensed by the enterprise.
- Examine all patent searches conducted by or on behalf of the enterprise in relation to the inventions of the enterprise.
- Confirm that all issued patents are being properly maintained and that the enterprise is current with all maintenance fees.
- Review and evaluate all threatened or pending interferences.
- Evaluate the scope and nature of any transfer of rights by evaluating all relevant agreements including licensing and manufacturing agreements.
- Investigate the underlying technology of the enterprise.

Copyrights
- Review all copyrighted works that the enterprise has created or commissioned, or to which it has acquired rights.
- Evaluate all work-for-hire agreements and contracts relating to consulting services and development work.
- Review all documents concerning copyright registrations, including applications, correspondence, transfers and security interests.
- Review all licences related to copyrighted works used by the enterprise.
- Review and evaluate the enterprise’s policy for identifying and protecting its copyrights in works it develops or has developed for it.
- Review and evaluate the efforts undertaken by the company to avoid claims of copyright infringement and obtain proper copyright clearances.
- Identify and evaluate all actual or pending claims of copyright infringement asserted against the enterprise.

Trade secrets
- Obtain an inventory of all material trade secrets utilised by the enterprise.
- Determine whether non-disclosure agreements have been executed with key employees, consultants and other individuals or entities having access to the enterprise’s confidential information.
- Determine whether non-compete agreements have been executed between the enterprise and its key personnel.
- Review employment records of key personnel.
- Consider the impact of recent arrivals and/or departures of key personnel.
- Evaluate the adequacy of exit interviews.
- Evaluate security policies, including physical, technical and administrative security procedures employed by the enterprise.
- Review and evaluate all relevant agreements, including know-how licences and technical assistance agreements.

Personal data
- Obtain an inventory of all the classes and types of personal data collected and processed by the enterprise, including the manner of collection, transmission and storage, with particular attention to trans-border data flow issues.
- Review contracts and policies pursuant to which personal data was collected.
- Consider legal and regulatory issues applicable to the personal data, including, for example, the European directive on the subject, the Canadian privacy law and relevant US legislation. More than 30 countries have enacted comprehensive data privacy laws that protect personal data. Even more countries have enacted industry and/or sector-specific legislation and many countries are actively considering proposals for comprehensive and/or sectorspecific data privacy laws.
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Ms Hildebrand has been lead counsel in many substantial transactions with particular emphasis on complex structures involving the development, distribution, exploitation, sale, license and outsourcing of intellectual property assets, e-commerce and web-enabled ventures. She regularly provides counsel regarding franchising ventures, product distribution, marketing, dispute mediation, the acquisition and sale of technology companies, and due diligence evaluations in the context of mergers, investments and venture capital transactions.

Some of the clients Ms Hildebrand has performed work for include State Street Bank & Trust Company, Telcordia Technologies, The CIT Group Inc, Viacom International Inc, Allied Signal (now Honeywell), Chase Manhattan, Hypovereinsbank, Citibank, Dell Financial Services and Life is Good Inc.

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Ms Klosek has served as a consultant to various directorate generals of the European Commission in connection with a number of studies relating to various aspects of the information society, including a study on international private law and electronic commerce, for which Ms Klosek served as the national expert for the United States.