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IP Due Diligence in M&A: Investigating Transferability of IP Assets, Blocking Rights, Liens and Other Encumbrances

Leveraging Diligence Results When Negotiating Price and Other Deal Terms

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IP Due Diligence in M&A: Investigating Transferability of IP Assets, Blocking Rights, Liens and Other Encumbrances

Leveraging Diligence Results When Negotiating Price and other Deal Terms

Daisy Darvall
Tyler Maddry
October 2020

Introduction

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Agenda

Considerations regarding the diligence team reviewing confidential information

- NDAs
- Clean teams
- Employing a consultant or expert

Due diligence issues relating to the target's agreements

- Identifying agreements that may impact the value of the target
- Corporate structure of the final entity and effects on licenses/IP-related agreements
- Evaluating the transferability of critical contracts from Target to Acquirer
- Restrictive clauses that may impact business goals of the Acquirer

Typical problems arising during due diligence

- IP ownership and lien verification
- Third-party roadblocks to commercial activity post-acquisition
- Handling opinions (e.g., FTO, validity, etc.) during due diligence

Leveraging due diligence results in deal negotiations

- Value drivers
- Deal points

Due Diligence - Context

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Overview

- Evaluation of IP assets and IP rights of a target business or entity which client is seeking to acquire for value
- Typical transaction scenarios include:
  - Acquisitions
  - Minority investments (VC transactions)
  - Joint Ventures
  - Joint Development Arrangements
- Scope of due diligence may vary by transaction type/value

Considerations: Confidential Information

- **NDAs**
  - Has Target run a process with multiple bidders that have reviewed due diligence under NDAs?
  - Confirm that NDAs will accrue to the benefit of buyer based on transaction structure (i.e., assignability)
  - If not transferable, include covenant to enforce by Target
  - Confirm whether destruction/return of confidential information provisions have been enforced
  - Confirm that customary restrictions on use and disclosure are included and for reasonable term

Considerations: Confidential Information

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- **Clean Teams**
  - Clean team may be appointed to navigate early discussions
  - Clean team can serve as a neutral and objective resource to conduct analyses that neither party can complete by itself (or complete as accurately) to assess a potential deal
  - Clean team adds greatest value in specific types of deals, i.e. mergers of equals, joint ventures and alliances in industries with close regulatory scrutiny, or with multiple parties
  - Clean team has usually unrestricted access to CI of all parties, to analyze potential value
  - Clean team can conduct early assessment of a deal’s business rationale, develop integrated business plan for the new entity, and support a formal negotiation

Considerations: Deal Team Review

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Employing a Consultant or Expert

- Consultants can assist in specialist review (e.g. technical aspects of Information Technology assets and systems, and cyber-security review of a Target)
- Can also provide valuation advice as to a Target's IP assets (e.g. patent litigators can be engaged to opine on the relative strength of a patent portfolio)
- Consultant may also provide advice on the protection of IP assets: areas of expertise include valuation and the quantification of damages in current litigations, fair market royalty rates, infringement and confusion, licensing customs and practices, and bankruptcy

IP Due Diligence – Agreements Impacting Value

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Open Source Software

- OSS risk arises from use of OSS without a policy or process
- Determine whether the Target has an OSS policy
  - OSS compliance officer or OSS review board
  - Required internal disclosures and records
  - Procedures for acquisition, use, development, modification, licensing, and distribution of OSS
  - Use of automated OSS detection and compliance tool
  - Legal review for distribution of OSS
  - Audits (third party and internal)
  - Participation in third party OSS projects

IP Due Diligence – Agreements Impacting Value

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Open Source Software

- To evaluate OSS compliance you need facts:
  - Name of OSS code module
  - Origin of the code
  - Applicable OSS license
  - Whether the code has been modified
  - Whether the code has been combined or linked (dynamic or static) with proprietary code
  - Whether the code has been distributed
  - Whether the code is used in a SaaS model
  - Whether the code is used only internally
- Then evaluate risks from non-compliance and remedial actions
- How much of the code is OSS?
- Consider effect on Target’s patent portfolio

IP Due Diligence – Agreements Impacting Value

Software Development – Vendor Agreements

- Identify the original software and subsequent contributors
- Did the Target own or have the right to modify the original software?
- Vendor agreement terms
  - Ownership of Deliverables
  - “Work made for hire” provisions and IP assignment
  - Access to source code
  - Worldwide, perpetual, irrevocable, license, with right to sublicense, to use, disclose and exploit pre-existing Vendor materials in Deliverables that survives termination of Vendor agreement
  - Transferability
  - Restrictions, consents, support, and documentation for use of OSS by Vendor

IP Due Diligence – Agreements Impacting Value

Employee Agreements

- Some companies do this well, many do not
- Best case is where all employees have executed an employee agreement on the first day of work
  - Actual assignment of IP, not just agreement to assign
  - “I hereby assign . . .” (*see Stanford v. Roche; FilmTec*)
  - Intellectual Property that I create, conceive, or reduce to practice (a) in the scope of my employment or (b) using employer’s resources, or (c) related to employer’s business…
- These assignments are especially important for unregistered IP which is not assigned separately (like patents)
- Remedial actions: have designated employees execute an assignment of IP created earlier

IP Due Diligence – Agreements Impacting Value

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IP Licenses

- Most important IP license terms are usually:
  - Scope of license grant, in or out
  - Payment obligations
  - Developed IP - ownership and right to use
  - Term and termination rights
  - Exclusivity
  - Sublicensing, and third party access
  - IP indemnification and liabilities
  - Anti-assignment and change of control provisions
- Evaluate how these terms may impact the acquired business
- Investigate breach and termination
- Review other types of agreements that may have IP license terms (e.g., JDAs, gov’t contracts, supply agreements, MSAs)

Due Diligence – Corporate Structure

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Identifying the Scope of Diligence

- IP and technology should be analyzed relative to the business, not in a vacuum
- Ask the business leaders about the acquired business
  - Identify the products/services of Target that generate the most revenue
  - Understand why the business leaders are buying the company
  - Ask about the most valuable IP/technology/data assets
  - Identify competitors
- The value of the diligence depends to a large extent on its relevance to the acquired business
- The corporate structure will also influence the scope and nature of due diligence

Corporate Structure - M&A Transaction Types

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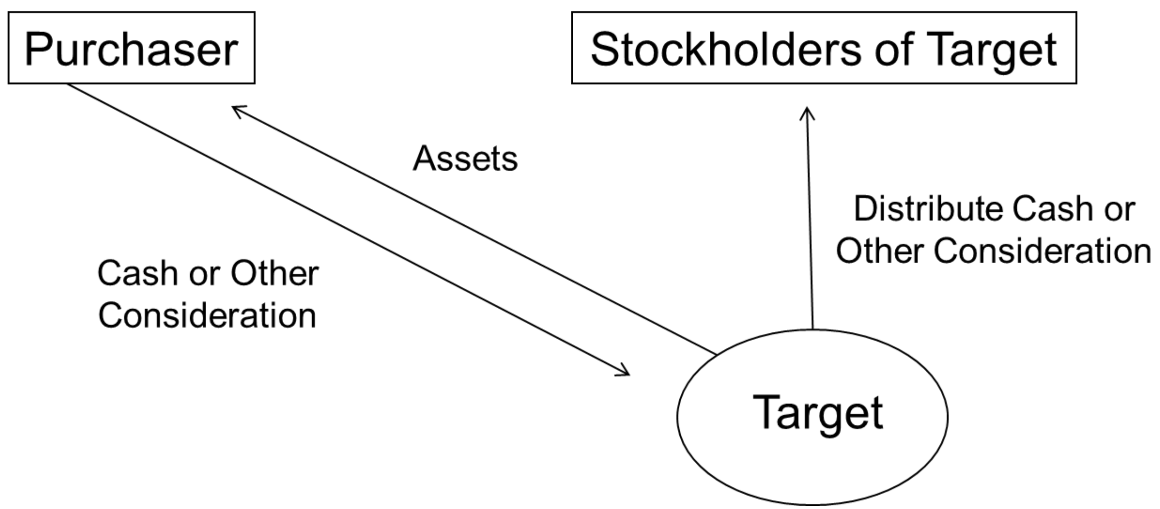
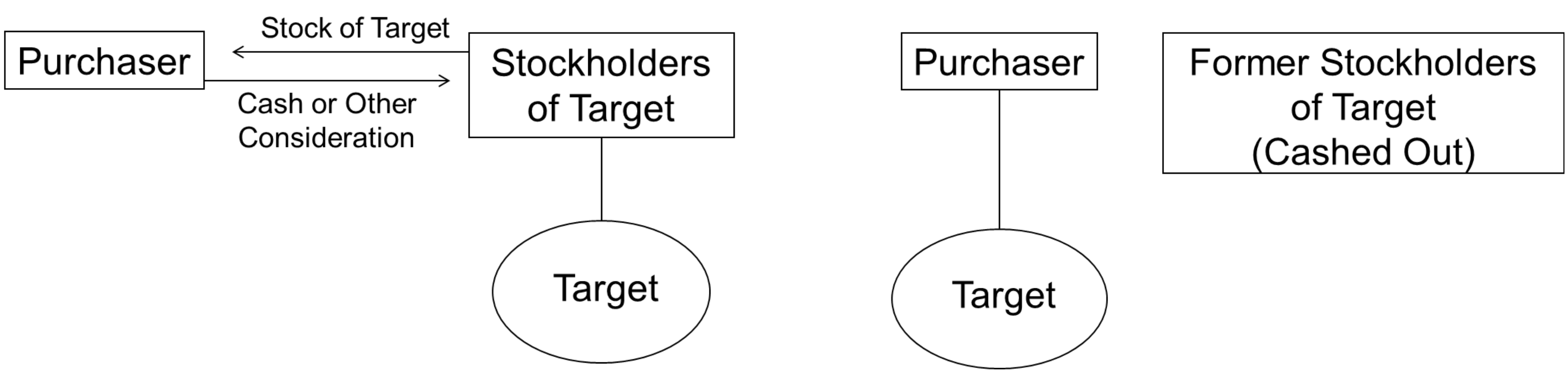
- Asset Purchase Transaction and Carveouts
  - Purchaser purchases assets of Target (Seller)
  - Parties agree on which assets and liabilities are included/excluded
  - If the transaction is a carve-out, inquire about what IP will be assigned and what licenses are needed post-Closing
  - Purchased IP assets can include registered IP, unregistered IP, and IP agreements
  - Assignments are executed and provided at closing
  - Anti-assignment/transfer provisions are clearly implicated



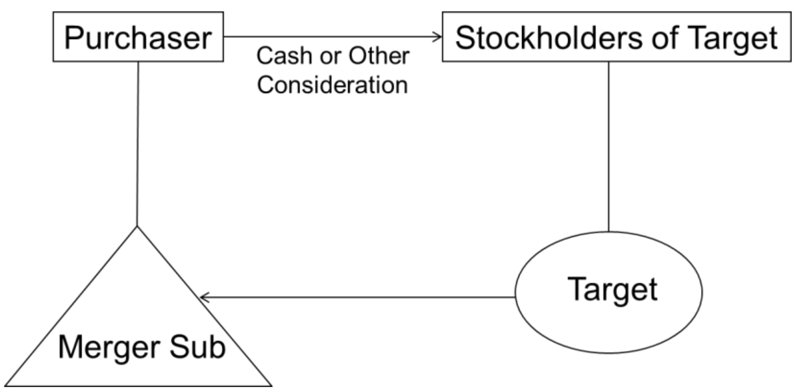
Corporate Structure – M&A Transaction Types

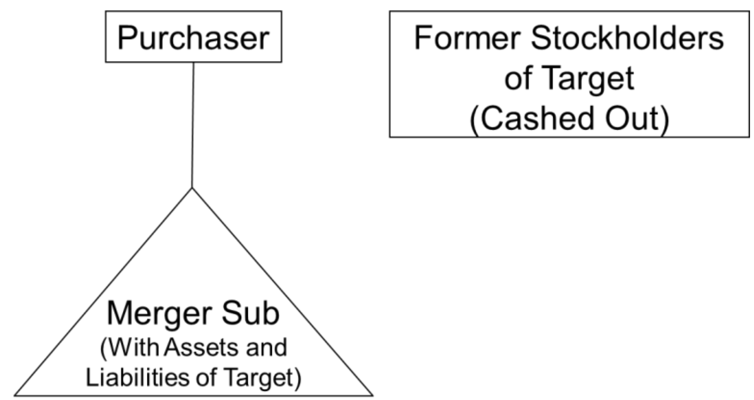
- Stock Purchase Agreement
  - Purchaser purchases stock of acquired company (Target)
  - Target becomes a subsidiary of Purchaser
  - IP assets and liabilities continue to be owned by Target
  - No post-Closing recording of IP assignments required (absent name change)
  - Change of Control provisions potentially implicated



Corporate Structure – M&A Transaction Types

- **Mergers:** Automatic transfer of assets to surviving company by operation of state law
- **Forward Merger:**
  - Target company merges directly into acquiring company (Purchaser) or subsidiary (Merger Sub) of the Purchaser and Merger Sub survives

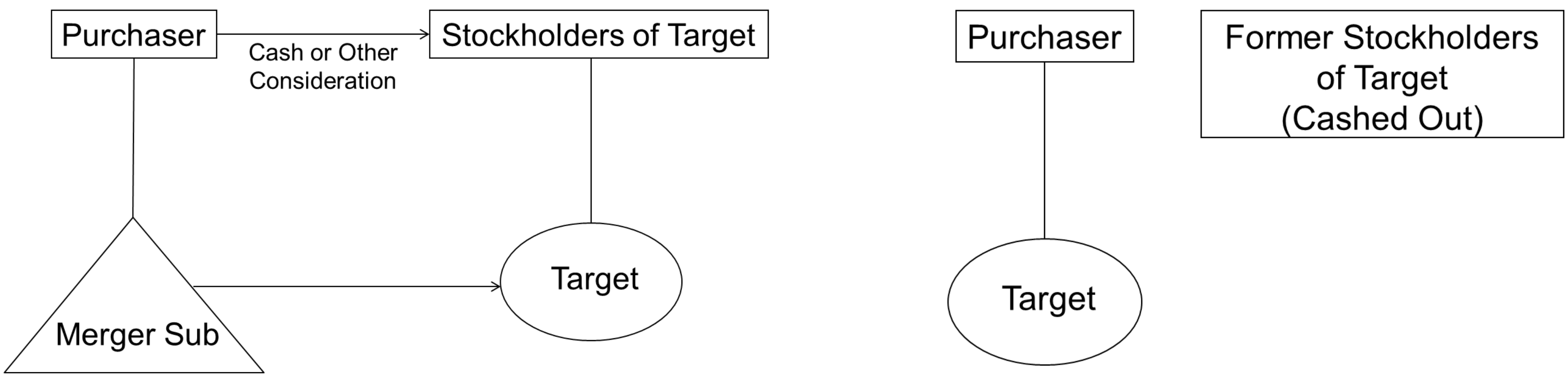




- Under state law, a forward merger is typically treated as an assignment or transfer by operation of law
- Under federal law, a forward merger is a restricted assignment or transfer by licensees of licenses involving patents and copyrights
- Recording with IP registrars may be required to reflect re-named owner of IP assets

Corporate Structure – M&A Transaction Types

- **Reverse Merger:**
  - Acquiring company (Purchaser) or its subsidiary (Merger Sub) merges into Target company
  - Target company survives and becomes subsidiary of Purchaser



  - A reverse merger generally does not effect a transfer of an agreement of the surviving Target
  - However, Federal law may characterize such a transaction as a restricted assignment (e.g., *SQL Solutions, Inc. v. Oracle Corp.*)

IP Due Diligence - Transfer Restrictions

- Part of due diligence review involves analysis of Target's contracts, including IP licenses – for restrictions on transfer – both anti-assignment and change of control provisions
- Transaction structure may be informed by contractual/licensing restrictions
- Change of control provisions vary considerably and may be implicated by virtually all M&A transaction forms
- Anti-assignment provisions are less varied and may have less impact due to transaction structure and state law interpretation
- Application of federal law in the context of patent and copyright licenses can result in a different outcome than state law would otherwise provide
- Transaction structure can affect logistical effort necessary to assign registered IP

Sample Anti-Assignment Provision

- "This License Agreement may not be assigned or transferred, ***by operation of law or otherwise***, by Licensee without the prior written consent of Licensor"
  - Inclusion of "operation of law" concept is intended to cover merger transaction structure under state law
  - The clause would also cover an asset purchase structure

State v Federal Assignment Dichotomy

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- *Effect of Merger under state law:*
  - "All property owned by, and every contract right possessed by, each domestic or foreign corporation or eligible entity that merges into the survivor ***is vested in the survivor without transfer,*** reversion or impairment." VSCA § 13.1-721
  - Most other state corporate codes have similar provisions

State v Federal Assignment Dichotomy

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- *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 2009):
  - Allowing state law to permit the free assignability of patent or copyright licenses would undermine the reward that encourages invention.
  - In the context of intellectual property under federal law, a license is presumed to be non-assignable and non-transferable in the absence of express provisions to the contrary. This is true even where state law permits the free assignability of a license.
  - In the context of a patent or copyright license, a transfer occurs any time an entity other than the one to which the license was expressly granted gains possession of the license.

Restrictive Clauses Impacting Business Goals of Acquirer

- Acquired IP licenses may have a scope broad enough for the Target's business, but not for the Purchaser. Consider:
  - Does the license grant extend to Affiliates?
  - Does the Purchaser need a right to sublicense or "have made" rights?
  - Geographic restrictions on any permitted activities
  - Field of Use restrictions
  - Other use restrictions (e.g., relating to a definition of Licensed Products or restrictions on permitted activities)
  - Exclusivity restrictions
  - Term and termination

Restrictive Clauses Impacting Business Goals of Acquirer

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- IT licenses often have additional restrictions that may be impacted by the transaction even if assignment is not an issue:
  - Seat count (i.e., can only be used on x number of computers)
  - Authorized user count (i.e., can only be used by certain employees)
  - Facility restriction (i.e., can only be used in X facility)
  - Exclusivity restrictions (i.e., Licensee may not use any other ERP system in any of its facilities)

Typical Due Diligence Issues – IP/IT Assets

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Software

- Obtain complete software inventory
  - Software developed by or for the Target
  - Third party licensed software
  - SaaS and cloud services
  - Open source software (OSS)
  - Name of program, functionality, associated products/services, developer, owner
- Identify most important software systems
  - Proprietary algorithms developed by Target
  - Customer-facing interfaces, services, and mobile apps
  - Trained machine learning (ML) models
  - Data analytics systems
  - Critical back-end processors

Ownership – IP Assets

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Software Development History

- Identify development history and developers
  - Employees
  - Contractors
  - Third party licensors
  - OSS
- Start identifying the documentation that shows ownership or license rights
  - Employee agreements
  - Vendor agreements
  - Third party licenses and service agreements
  - OSS licenses
- Identify copyright registrations/applications for Target-developed software

IP Due Diligence – IP Assets

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Trade Secrets, Proprietary Information and Data

- Difficult to identify but increasingly valuable
  - Unpatented technical Information and know-how
  - System diagrams, specifications, interfaces, algorithms, proprietary processes
  - Training data, weights and parameters, training algorithms, and derivative data for AI/ML models
  - Proprietary databases, data and reports
  - Secret formulae and manufacturing processes
  - Business plans, customer information, pricing information, other financial information
- Ask what it is, how valuable, where stored, who has access, developers, and ownership
- Interview the senior engineers with hands-on experience

IP Due Diligence – IP Assets

Patents

- Identify worldwide issued patents, published applications, invention disclosures, and abandoned patents and applications
- How well do the patents and applications correspond to the most important products/services of Target?
- Key inventors
  - Are they still with the Target?
  - Do they have other patents not owned by Target?
  - Inventor publications before patent filings?
- Review assignment records; verify ownership
- Identify security interests/liens for release at Closing
- Verify maintenance fee payments
- Identify litigation and administrative proceedings, e.g., post grant review
- Review Target's process for protection of inventions

IP Due Diligence – IP Assets

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Trademarks

- Identify worldwide registrations, applications, prosecution status, rejections, and renewals
- Identify domain name registrations and social media accounts
- Review marks used on Target's website, social media, advertising and marketing materials, sales brochures, packaging, etc.
  - Identify re-branding and wind-down/transitional licenses required
- Assess use of unregistered and registered marks
- Evaluate policies and procedures for selecting, clearing, registering, marking (® ™), and policing marks
- Identify security interests/liens for release at Closing
- Identify litigation, opposition and cancellation proceedings

IP Due Diligence – IP Assets

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Copyrights

- Identify worldwide registrations, applications, rejections, and renewals
- Review all copyright licenses used by Target
- Review and evaluate Target's policy for identifying and protecting its copyrights in developed works
- Review and evaluate efforts undertaken by Target to avoid claims of copyright infringement and obtain proper copyright clearances
- Identify security interests/liens for release at Closing
- Identify litigation, opposition and cancellation proceedings

IP Due Diligence – Infringement Risk

Risk of IP infringement or Misappropriation

- Usually the most important risk to analyze
  - Search for public information:
  - Federal IP suits in the U.S. can be searched on PACER (www.pacer.gov)
  - State law cases (e.g., trade secrets) take more time and effort to find
  - Also search for breach of contract claims related to IP and technology contracts

IP Due Diligence – Infringement Risk

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Risk of IP infringement or Misappropriation

- Information sources other than public litigation records are generally confidential and obtained from your IP counterpart:
  - Opinions of counsel on invalidity/unenforceability/ noninfringement of third party IP
  - Prior settlement agreements
  - Failed settlement negotiations
  - Correspondence, including cease and desist letters, infringement allegations, breach allegations, offers to license
  - Freedom to operate searches, studies and opinions
  - Validity searches
- Inquire about software audits

Third-Party Roadblocks to Commercial Activity Post-Closing

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Potential Third Party Claims

- Competitor of Target not concerned until public announcement by Purchaser with deep pockets
  - Target may downplay or not appreciate risks to some extent
  - Competitor may recognize valuable technology and much greater threat after acquisition
  - Take a hard look at whether IP disputes are actually resolved
  - Target's confidential information on infringement risk may suggest future lawsuit
- Former employee or contractor of Target not interested until public announcement
  - Long, complicated technology development history may suggest potential issues with IP ownership
- Profiting from noncompliant use of open source software
- In some cases patent searching or infringement analysis ("freedom to operate") may be worthwhile

Handling Opinions in Diligence

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Written Opinions

- Formal opinions on non-infringement, invalidity and unenforceability suggest the Target had serious concerns with infringing third party patents
- Target has a legitimate need to preserve attorney-client privilege
- Purchaser has a legitimate need to understand the infringement risk
- Common interest doctrine is effective in some states for M&A transactions
- Other states have a stricter requirement for identical legal interest and threat of litigation
- After identifying whether there are opinions, evaluate the risk of waiving privilege and whether alternatives short of reviewing the opinion are sufficiently informative.

Leveraging Due Diligence Results in Deal Negotiations

- The information from due diligence can be used as leverage in negotiations, e.g., reassessing the valuation of the Target upon discovering:
  - Narrow patent coverage on key products and services
  - Abandonment or expiration of multiple patents and applications
  - Use and distribution of open source software with no OSS policy, compliance process, or manager
  - Chain of title problems
  - Multiple inbound licenses with large collective royalty obligation
  - Careless use of key trade secrets and proprietary information
- Due diligence information can also be used to justify
  - Stronger IP reps and warranties
  - Corrective actions such as IP assignments from key employees

Value Drivers: IP Reps – Title

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- Exclusive Ownership
  - Target exclusively owns the IP used in the business, free and clear of all liens, except for inbound licenses that are scheduled
  - No suits, allegations or threats challenging ownership or validity of the IP used in Target's business
  - Target has written agreements containing actual IP assignments executed by past and current officers, employees and contractors
  - None of the Target's IP is the product of any joint development with a third party
  - None of the Target's IP has been developed with government funding

Value Drivers: IP Reps – Open Source Software

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- No OSS used in products/services/operation of business, except as scheduled
- No OSS has been distributed, modified or used in SaaS model except as scheduled
- Target is in full compliance with all OSS licenses
- No obligation to distribute source code, except as scheduled
- Buyer not restricted from charging a fee or restricting its customers' modification or distribution rights
- Target has not contributed OSS to any OSS project, except as scheduled
- Schedule lists all OSS used in the Target's business
  - Identifies OSS code, origin of code, OSS license, whether OSS is used internally, for SaaS, distributed and/or modified
  - Identifies how OSS code is combined with or interfaces to other code (e.g., dynamic or static linking)

Value Drivers: IP Reps – Software and IT Agreements

- Schedule includes complete list of software used in the business
  - Exception to scheduling requirement for commercial off the shelf (COTS) software below specified annual amount
  - Target exclusively owns software, except where schedule indicates it is licensed
  - Owned software was developed by employees or contractors who have executed agreements transferring ownership
- Target has provided copies of agreements
- Licenses are transferrable, except as identified on schedule
- Licenses will continue to be in force after closing
- No notice of breach, breach, or cause for termination
- No software audits except as identified on schedule

Value Drivers: IP Reps – Noninfringement

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- No Infringement by Target
  - Neither the operation of the business, nor use of Target's IP or technology, infringes, misappropriates, or otherwise violates any third party IP
  - Target has not received any cease and desist letters, threats, allegations, or offers to license third party IP
  - No pending or settled IP litigation, except as scheduled
  - No infringement or misappropriation immediately after closing
- No Infringement by Third Parties
  - No infringement, misappropriation or other violation by third parties of Target's IP

Additional Considerations - IP Assignment and Transfer

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Assignment of Unregistered IP

- IP assignment delivered at closing in asset purchase
  - Purchased IP defined broadly as all IP related to or used in the business, or related to the products and/or services, including without limitation the IP listed on Exhibits…
  - Identify and list material, unregistered IP such as software, technical information, customer information, and data
- Consider whether any physical transfer or electronic access to IP assets is necessary and whether explicit obligations are appropriate
  - Files, manuals, technical documents, software, data, network access
  - In some situations, e.g., carve out transactions, the license scope, access rights, and obligation to provide access or copies can be complicated

Additional Considerations: Ancillary License Agreements

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- Common for one party to require access to some IP of the other party post-closing
- Draft license agreement to provide those rights
- IP license terms to consider:

• To Licensee (and Affiliates?) • Licensed IP/Software/Data • Exclusive or nonexclusive • Field of use restrictions • Permitted activities (make, use, sell, offer to sell, import, distribute, copy, modify, etc.) • “Have made” rights	• Use restrictions • Territory • Term and termination of license • Royalties or other payments • Right to sublicense and third party access • Transferability

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Thank You

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