The Deal

Evaluating IP Assets in an M&A Transaction

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In an age of deals driven by new technologies, and the intellectual property rights that protect them, it is vital that the IP be handled properly in any M&A transaction. Now, with the weakening of the economy, the cost of "getting it wrong" has increased even more, meaning the importance of having these critical, intangible assets properly evaluated has equally increased. It is not, however, unusual for transactional attorneys to utilize M&A generalists, rather than IP specialists, to handle IP-related due diligence and warranties. Doing so brings with it many risks, and things can easily go wrong as a result.

There are many reasons why generalists are sometimes relied upon to address IP issues on a deal, including client concerns about costs, but none of them are good enough to warrant the risks. The consequences can include getting the due diligence wrong, getting representations and warranties wrong, buying assets that do not deliver the expected market exclusivity and even, in the worst cases, spending money on litigation instead of business operations. Using IP specialists mitigates these risks for both buyers and sellers, and this should be communicated to clients early on in the process.

The IP specialist plays an important part in the due diligence side of any M&A transaction involving intellectual property assets. For buyers, the specialist confirms (among other things) that the seller has the rights necessary to conduct the business and that existing contracts will not tie the buyer's hands when they take over. In many transactions this is easily determined; in others, however, it is not, and requires a specialist's skilled determination. For example, exclusive licenses limiting IP rights to a particular field of use must be reviewed to ensure their scope is adequate for how the buyer intends to use them in doing business, and that provisions governing enforcement provide adequate protection. An IP specialist will also review these licenses in terms of how, for example, they affect the buyer's ability to defend an underlying patent's validity, which could be vulnerable to attack because a third party has rights to those same patents for use in an entirely unrelated field. Validity attacks are not limited to any particular field of use and seek to undermine the patent as a whole. A third party that seeks to enforce those patents in an unrelated, noncompeting field may leave the buyer unable to enforce those same patents in the market space occupied by the acquired business. This is something IP specialists understand, but generalists may miss.

Another dangerous pothole may loom in reviewing existing employee agreements. Buyers should use IP specialists to review the seller's existing agreements with employees, consultants, customers and those authorized to use its technology, as these are all potential sources of risk to IP rights. Some companies wrongly assume, for example, that all IP developed by an employee or consultant can be treated as "work for hire," but this is only the case with copyrights. Patents, trade secrets and other IP doesn't fit neatly into that category, and it is important, in almost all cases, to have a written agreement covering IP developed by employees. As a result, IP specialists should be used to ensure a seller has comprehensive written agreements covering all IP developed by employees and consultants. Similarly, they should review customer agreements to ensure infringement indemnities are properly limited so as to address, for example, situations where the relevant product is used in combination with other products or services.

IP specialists play an equally important role on behalf of sellers, particularly with respect to disclosures during the due diligence process. An IP specialist should conduct a thorough review of a seller's portfolio before a prospective buyer commences its own due diligence. This will ensure a seller does not overstate the value of its portfolio, and that it actually owns the rights it claims to own. Similarly, while disclosing a published patent application does not present any risks, doing so with a pending patent is not always advisable. Assessing whether or not to disclose an unpublished patent application is most definitely something best handled by an IP specialist who intimately understands the inner workings of the U.S. Patent and Trademark Office.

Sellers will also benefit greatly from an IP specialist's experience when making representations and warranties in the transaction agreement. A generalist, for example, may not understand that sellers should not be expected to warrant that a patent is in fact valid and enforceable, only that it is presumed valid and enforceable. This is a crucial difference; only courts can determine whether or not a patent is valid and enforceable. There are also decisions to be made about listing or otherwise identifying copyrighted works, which are best left to an IP specialist. While listing all of a seller's copyrighted works in a schedule is simply not realistic (any original works - including, for example e-mails - are covered by copyright), listing just registered copyrights may not be enough. Much of a company's copyrighted work, such as website content and source code, may not be registered with the U.S. Copyright Office. An IP specialist is much more experienced than a generalist at making this distinction and deciding what should and should not be listed.

Another classic oversight sellers sometimes make, and buyers too often accept, is to warrant that the seller's patents do not infringe other patents. Tangible things, processes and (sometimes) even methods infringe patents, but patents do not infringe patents. And those tangible things, processes and methods may be covered by not only the seller's patents, but by third-party patents as well. Buyers need to appreciate that, just because the seller's patents cover a particular product, this does not necessarily mean that the seller doesn't need to own or license other patents to avoid infringement claims.

Finally, one of the most significant developments in M&A in the past 10 years is the increasing frequency with which buyers are granting licenses back to sellers to use the relevant IP for (ordinarily) non-competing purposes. Limiting license grants to ensure they do not allow for use in a competing manner can be tricky; knowing (and understanding) the scope of the claims of the patents being licensed back, or the functionality of software being licensed back, can be just as important as a well-drafted noncompete. Indeed, if properly done, that license back to the seller can afford a buyer greater, and longer lasting, protection than a typically time-limited noncompete.

Specialists, be they tax, environment, IP or other, know how easy it can be for generalists to miss seemingly small, but important, points. Generalists may or may not appreciate this, but the real challenge for specialists and generalists alike can be making sure the client understands this. For transactional lawyers of every stripe, communicating this point to clients, and making sure those clients enthusiastically embrace the added value of keeping specialists involved from the start, can be just as important as being a strong advocate for your client when you sit down at the negotiating table.

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