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Intellectual Property Considerations in M&A Due Diligence

ABSTRACT

Due diligence is of key importance in identifying, allocating and mitigating risk in M&A transactions. The review of intellectual property matters is an essential part of each due diligence exercise. The related evaluation encompasses the review of publicly available information, as well as the contractual relations of the target. Proprietorship, geographical spread, status and term of the protection of registered intellectual property is assessed for evaluating the target's technology. The manner how intellectual property was acquired, interdependence from seller is assessed, and inbound and outbound licenses must also be carefully reviewed, especially in light of the post-closing operational matters and possible integration of the target into the buyer group. Expert knowledge of transactional theory, intellectual property and contract law is necessary to identify, evaluate and mitigate risks stemming from intellectual property-related matters.

KEYWORDS: Legal due diligence, M&A, intellectual property, warranty, indemnity, due diligence stages, due diligence report

I. INTRODUCTION

From an abstract perspective, in the M&A context, certain transaction steps may be viewed as part of the parties' attempts to allocate risk. Due diligence ("DD"), as a transaction stage (ideally conducted pre-signing) is essential in identifying (and thus, allocating and addressing) matters that (may) pose any risk to the acquirer post-completion.

Intellectual property rights ("IP") are not equally material in respect of the operation of every company or in the context of each acquisition. Nevertheless, to avoid a lemon purchase, each transaction team must keep IP considerations in mind, and, where IP-infused industries and IP-focused acquisitions are concerned, IP matters must be of primary focus during the DD and drafting the transaction documents.

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This paper provides a practical, simplified overview – from an IP point of view – of the stages of M&A transactions, as well as the purpose, disciplines and process of DD exercises.

The plan of this summary is as follows. Part II summarises the stages of M&A transactions. Part III reviews the purpose, disciplines and typical course of legal DDs. Part IV focuses on the particularities of IP DD processes. Part V presents the main considerations and typical issues uncovered during the IP DD. Part VI recaps the essence concluded in Parts II to V.

II. STAGES OF AN M&A TRANSACTION

M&A literature identifies two-stage to ten-step classifications, most drawing the theoretical border lines between the preliminary, preparatory, merger/acquisition and post-merger/post-acquisition phases of transactions.

In general, typical M&A transactions encompass the following main stages and milestones:¹ (i) preliminary discussions; (ii) establishing non-disclosure arrangements; (iii) elaborating letters of intent or term sheets; (iv) drafting and negotiating the transaction documents; (v) signing the transaction documents; (vi) interim period between signing and the completion of the transaction;² (vii) completion of the transaction;³ and (viii) post-closing period.

Steps from (i) through (iv) serve as the preliminary, pre-signing phase of a transaction, focused on value exploration and feasibility assessment. Simply put, during such a “courtship phase” the management of the target becomes familiar with “the advantages of the proposed marriage” and how it is envisioned they will be brought about is discussed. The “marriage ceremony” closes the second phase of a deal, encompassing mainly legal steps, which is followed by the post-closing “honeymoon” phase, wherein real integration begins. Adjustment takes place after the “honeymoon” phase.⁴

¹ DLA Piper LLP (US), *Mergers and acquisitions: overview of a transaction*, Available at: <https://www.dlapiperaccelerate.com/knowledge/2017/mergers-and-acquisitions-overview-of-a-transaction.html> (Last accessed: 31 July 2019).

² The signing and exchange of the transaction documents and the completion of an acquisition may occur simultaneously or be split in time. In the former case, namely, when an interval between signing and closing is necessary, exchange is approached as a separate transaction stage and typically involves the parties making a commitment (the “engagement”) in the signed share sale and purchase agreement (“SPA”) to proceed with the transaction. [Thomson Reuters Practical Law Corporate, *Exchange and completion: share purchases*, <https://uk.practicallaw.thomsonreuters.com/7-107-376> (Last accessed: 31 July 2019)].

³ Closing (or completion) is practically the “marriage ceremony” of the deal, as a result of which the ownership over the target transfers to the buyer.

⁴ R. Calipha, S. Tarba and D. Brock, *Mergers and acquisitions: A review of phases, motives, and success factors* [quoting Vance, Fery, Odell, Marks and Loomba (1969)], in Cooper and Finkelstein (eds), *Advances in Mergers and Acquisitions*, (Emerald Group Publishing Limited, Bingley, 2010) 1–24. [https://doi.org/10.1108/S1479-361X\(2010\)0000009004](https://doi.org/10.1108/S1479-361X(2010)0000009004)

During the preliminary phase, it is vital for a purchaser that the target company (“Target”) is assessed from (*inter alia*) a legal, tax, operational and financial point of view, by conducting the respective DDs. DDs are performed by specialist professionals, ideally prior to the negotiation of the transaction documents and after the execution of non-disclosure agreements, term sheets and letters of intent.

III. DUE DILIGENCE PROCESS

1. Rationale

In M&A transactions, DD “refers primarily to an acquirer’s review of an acquisition candidate to make sure that its purchase would pose no unnecessary risks to the acquirer’s shareholders”.⁵ This process of verification, investigation or audit of a potential deal or investment opportunity is aimed at confirming all facts and financial information, and verifying anything else that was brought up during an M&A deal or investment process.⁶

The basic goal of a DD is to assess and identify the benefits and drawbacks of a contemplated transaction, taking into account the liabilities incurred in connection with it, by investigating all relevant aspects in the past, present and future of the target. DDs aim to reduce negotiation risk and deal risk by enabling the purchaser to verify whether the target is indeed the one that it intends to buy. In this regard, current and future sales and profits, assets, liabilities and matters against which protection should be sought are identified. Deal risk is reduced through adequate pre-completion and post-acquisition planning, one of the key elements of which are DDs.⁷

2. Disciplines

A diligent buyer may want to conduct DDs in various disciplines, usually encompassing (among others) financial, commercial and legal (these three widely treated as the “main” DD topics), human resources, management, pension, tax, environmental, IP, IT, technical, operational, property, and anti-trust assessments. The scope of the DDs actually conducted will be determined by the prospective purchaser.

⁵ L. A. Reed and C. M. Elson, *The art of M&A due diligence, navigating critical steps and uncovering crucial data*, 2nd ed. (McGraw-Hill Education, New York, 2010) 6.

⁶ Corporate Finance Institute, *What is Due Diligence?*, <https://corporatefinanceinstitute.com/resources/knowledge/deals/due-diligence-overview/> (Last accessed: 31 July 2019).

⁷ P. Howson, *The Essentials of M&A Due Diligence*, 1st ed. (Routledge, London, 2018) 6–7. <https://doi.org/10.4324/9781315107097-1>

It is general practice that the legal DD conducted in respect of the transaction also covers – the depth of assessment varying on a case-by-case basis – IP and IT matters. Legal DD never encompasses assessment from a technical perspective; therefore, if the IT systems applied by the Target or its business necessitates the operation of an elaborate and/or highly particular IT background, technical IT DD is necessary.

3. DD process

As a general rule, DD processes are driven by transactional lawyers (most commonly, corporate attorneys), as well as tax and financial specialists.⁸ Depending on the business of the target, subject-matter experts (“SME”) may also need to be involved.

Prior to the commencement of the DD, counsel should clear with the client, among others, (i) the DD budget; (ii) scope of review; (iii) the type of report that must be prepared; (iv) the applicable deadlines; (v) review and issue thresholds; and (vi) potential deal-breakers. Usually, either a counsel coordinating the legal DD team or a project manager coordinating the DD of the various SMEs serves as a contact point and distributes requests and information among the DD team and the sellers.⁹

The DD phase commences with the delivery of a list of enquiries, known as “information request list” or “initial request list”, referred in jargon as the “IRL”, which is usually drafted by the purchaser’s legal advisors (in the case of a buyer DD) (“IRL”). The IRL intends to address the most common issues that may arise in relation to the Target and its operation (including IP and IT matters), as well as the transaction itself, by requesting either the (i) the sellers’ confirmation as to the absence of certain issues (e.g. the absence of patent litigation related to the operation of the Target) and as to compliance with obligations binding the Target), or, if such may not be provided; (ii) disclosure of relevant documentation. Standard IRL requests related to the Target IP (defined below) are described in Part IV below.

Where disclosure is inconsistent, or otherwise contains gaps (e.g., pages are missing, the disclosed documents refer to relevant documents that have not been disclosed or the sellers provide neither confirmations nor documents in respect of the requests set out in the IRL), it is prudent for the purchaser’s counsel to submit further requests to the sellers for clarification and disclosure.

Apart from written information disclosed to the reviewing counsel, it is also common practice to ensure the SME’s access to the management of the Target by holding management calls (interviews), during which any matter uncovered by the DD may be further addressed.¹⁰

⁸ Thomson Reuters Practical Law Corporate & Securities, *Due Diligence for Private Mergers and Acquisitions*, <https://uk.practicallaw.thomsonreuters.com/8-381-0512?originationContext=knowHow&transitionType=KnowHowItem&contextData=%28sc.Default%29&comp=pluk> (Last accessed: 31 July 2019).

⁹ Ibid.

¹⁰ Ibid.

IV. IP DUE DILIGENCE¹¹

1. Objective

The primary objective of the buyer's IP counsel during the DD is to ascertain whether, with the effect of the acquisition, the Target will remain entitled to use all IP necessary for the conduct of its business (as carried out prior to the acquisition), as well as to develop its operation as planned and in line with the intentions of the buyer.¹² Further objectives of the buyer DD include the identification of IP-related (*i*) liabilities that may affect the deal (and IP asset) valuation; and (*ii*) obstacles that must be resolved and mitigated prior to closing.¹³

These goals are achieved through the review and evaluation of the documents and information outlined in sections IV.2. and IV.3. below, and the consequent drafting solutions applied in the transaction documents.

2. Preliminary IP considerations, information and document requests

IP SMEs involved in the DD should take various factors into account prior to drafting/commenting on the IRL and starting on the DD itself: the structure of the M&A transaction at hand (share or asset purchase, forward or reverse mergers),¹⁴ the identity of the acquirer, the industry and geographic scope of the operation of the Target and the presumed materiality of the Target IP, as well as any constraints (e.g., budget, expedited

¹¹ Note that information technology ("IT"), as well as data protection matters usually form an independent area of the DD processes. Therefore, this summary concentrates on "classical" IP DD matters and does not encompass IT and data protection considerations.

¹² C. Connolly, *Intellectual property: share purchases, how to deal with intellectual property rights on a share purchase or other acquisition*, <https://uk.practicallaw.thomsonreuters.com/Document/Ib55548a8e83211e398db8b09b4f043e0/View/FullText.html?listSource=Foldering&originationContext=MyResearchHistoryRecents&transitionType=MyResearchHistoryItem&contextData=%28soc.Search%29&VR=3.0&RS=cblt1.0&navId=BE477F2DE6E97F2072CCC2E3FBE34ECD&comp=pluk> (Last accessed: 31 July 2019).

¹³ D. Glazier and T. Rubin, *Intellectual Property: Stock Purchases and Mergers*, [https://uk.practicallaw.thomsonreuters.com/6-506-9152?originationContext=document&vr=3.0&rs=PLUK1.0&transitionType=DocumentItem&contextData=\(sc.Default\)#co_anchor_a988992](https://uk.practicallaw.thomsonreuters.com/6-506-9152?originationContext=document&vr=3.0&rs=PLUK1.0&transitionType=DocumentItem&contextData=(sc.Default)#co_anchor_a988992) (Last accessed: 31 July 2019).

¹⁴ In mergers and stock purchases, the acquirer will acquire control over the IP rights owned by the Target either directly or indirectly. In asset purchases, the buyer will acquire only certain assets and liabilities. In the former case, particular consideration must be given by counsel whether the transaction itself will impair any target IP rights, trigger any change-of-control provisions or necessitate third-party consents or special measures to ensure the continuous right of usage of the target (or buyer). (See footnote 12.)

timeline).¹⁵ It should also be established whether the Target is an operating company that is a party to IP agreements.

The materiality of the IP may be assessed based on, among others, the current or future revenue generated by royalties or license fees payable or received regarding the licensing of the IP, as well as the lack of commercially available alternatives to the IP, and the applicable replacement cost.¹⁶

IP-related transactional DDs aim to encompass the broadest scope of IP owned and/or used, exploited or otherwise held for use by the Target (“Target IP”). *Per definitionem*, Target IP usually includes registered and unregistered IP rights (including, know-how, trademarks, patents, copyright, inventions, database rights and domain names).¹⁷

Upon the commencement of a DD process, it is standard for the legal counsel of the buyer to request:¹⁸

(i) a summary list of the Target IP, distinguishing between registered and unregistered IP, as well as IP in respect of which the application for registration is ongoing at the time of the request, together with (where relevant) copies of documents relating to such IP;

(ii) confirmation that the Target IP is valid and all registrable IP has been duly registered;

(iii) details of costs related to maintaining the registered Target IP (where relevant);

(iv) licences, collaboration agreements and consents granted in respect of the Target IP that forms the basis of the use by the Target of Target IP originally owned by third parties;

(v) details of any actual (i.e., ongoing) disputes, or threatening disputes (e.g., of which notice or a cease- and desist-letter has been served on the Target or on the sellers), especially of those concerning the ownership or validity of Target IP;

(vi) documentation related to any (known or suspected) infringement by the Target of third parties’ IP rights, or the confirmation that no such act has been committed by the Target and no such claim has been put forward;

(vii) details of shared IP rights, clearly specifying if an IP right is held jointly or is licensed from or to an entity in the sellers’ group;

¹⁵ Thomson Reuters Practical Law Intellectual Property & Technology, *IP Due Diligence Issues in M&A Transactions, Checklist*, (based on original materials by Elaine D. Ziff and Grace Del Val), www.uk.practicallaw.thomsonreuters.com (Last accessed: 31 July 2019).

¹⁶ *Ibid.*

¹⁷ McDermott Will & Emery, *The top five intellectual property traps in M&A transactions*, <https://www.lexology.com/library/detail.aspx?g=ea39b939-6d90-4536-984c-e9e1b4fccfd5> (Last accessed: 31 July 2019).

¹⁸ Thomson Reuters Practical Law Corporate, *Legal due diligence information request: long form: share purchases*, <https://uk.practicallaw.thomsonreuters.com/> (Last accessed: 31 July 2019).

(*viii*) details of whether any Target IP has been developed by the employees of the Target (or the seller group), or whether by independent contractors, as well as the relevant contracts on assignment of the Target IP rights to the Target.

3. Publicly available information

In addition (and prior) to the review of the documentation disclosed by the sellers, it is useful to gather information from public sources in relation to the Target's IP. This preliminary review should encompass checking the websites used by the Target (which may reveal the set of trademarks or other IP used by the Target) and publicly available IP databases (including especially certified registers (in Hungarian "közhiteles nyilvántartások").

It is therefore standard for Hungarian IP counsel to check, in addition to the documents disclosed by the sellers:

(*i*) the online database (in Hungarian: "E-nyilvántartás adatbázis") of the Hungarian Intellectual Property Office (in Hungarian: "Szellemi Tulajdon Nemzeti Hivatala") ("HIPO")¹⁹ in respect of (*a*) applications submitted to and/or granted by the HIPO regarding industrial IP; and (*b*) usage rights granted in respect of orphan works (in Hungarian: "árva művek");²⁰

(*ii*) the online database²¹ of the Council of Internet Providers (in Hungarian: "Internet Szolgáltatók Tanácsa") ("ISZT") in respect of ".hu" top level domain names. The so-called "whois" record, retrievable from this page, reveals the person registering the domain name²² and the time of registration, as well as the name and contact details of the registrar. Data reflected in the ISZT database is updated based on the official databases maintained by the registrars;

(*iii*) the webpage through which the Target is available on the internet. In the majority of cases, the webpages reflect the trademarks and trade names used by the Target;

(*iv*) sample official documents (e.g., invoices, customer communications) issued by the Target, as part of its operations.

¹⁹ Accessible at the following webpage: www.sztnh.gov.hu (Last accessed: 31 July 2019).

²⁰ In addition, it is standard to consult the the online database (in Hungarian: "E-kutatás adatbázis") of the HIPO in respect of industrial properties. Data related to industrial IP registered or applied for in Hungary, or granted (and effective) internationally or at an EU level may be accessed in this database. Note that the "E-kutatás" database is not a certified register.

²¹ Accessible at the following webpage: www.domain.hu (Last accessed: 31 July 2019).

²² Note, however, that, for GDPR compliance, the name of natural persons is not reflected on the whois record. This could pose particular difficulties in an M&A transaction where the person registering the domain name is not an employee or official of the Target but a person belonging to the sellers' group.

When performing public searches, it is useful to keep in mind that there may exist entries standing in the name of a predecessor-in-title (or, more usually, the legal predecessor or previous corporate name of the target).²³

V. KEY IP CONSIDERATIONS

At a minimum, the assessment in point IV.3. above will provide information relating to the proprietorship, geographical spread and term of the Target's registered IP, and may serve as a basis for the evaluation of the Target's technology (through the value of the patents and published patent applications of the Target). Usually (but to be verified in each case, to the extent possible) seller/Target records of registered IP are accurate. As the buyer would acquire the Target itself under the SPA, generally no further steps would be required to ensure that the Target retains its ownership over that IP.²⁴

Unlike the assessment of registered IP, the identification and evaluation of unregistered IP rights could prove more difficult. This could pose particular difficulties in unregistered IP-infused industries, such as software production, publishing and fashion, as well as entertainment. Therefore, the due review of the Target's documentation will be key for establishing whether ownership exists and is defensible.

In each case, IP counsel should review the IP search reports against disclosure to verify the accuracy and completeness of the latter, and whether there are any gaps in the chain-of-title, or there remains any unreleased security or other issues in respect of the protection of the Target IP. In the event of any discrepancy between public sources and the information disclosed by the sellers, counsel should confirm the reason for such a discrepancy and double-check the accurate scope of IP that will be included in the transaction.²⁵

Counsel must also understand how the Target IP has been developed or acquired (e.g., whether the Target IP has been developed jointly with third parties, or by employees, consultants or other independent contractors of the Target, or, with funding or resources from any government entities or academic institutions) and review the underlying documentation. In the case of acquired IP, the assignment provisions of the relevant agreements must be double-checked to ensure that the transfer of ownership has been completed, without any additional conditions or obligations.²⁶

A core area of review is the IP licences concluded by the Company, whether inbound or outbound. As the form of licences varies, some may be easily identified (e.g., trademark licenses), while others may be less obvious (e.g., research and development,

²³ See footnote 12.

²⁴ Ibid.

²⁵ Ibid.

²⁶ Ibid.

consulting, manufacturing, supply or distribution agreements). Although disclosure in respect of in-licensed IP will mostly depend on the seller, IP counsel should normally try to identify the following in each case:²⁷

- (i) the role played by the Target (licensee-licensor, assignee- assignor);
- (ii) IP involved;
- (iii) exclusive or non-exclusive nature of grant;
- (iv) geographical scope of the licence and whether there are any restrictions on export;
- (v) term of the arrangement, remaining term of the protection of the underlying IP, any post-termination restrictions;
- (vi) grant-back, right of first refusal, right of first offer or option provisions;
- (vii) cases of termination, especially if a change-of-control clause will be applicable (in Hungarian: irányításváltozási klauzula) in relation to the contemplated acquisition; and
- (viii) royalties payable on the grant.

A material issue to analyse is how the licensing arrangements of the Target will be affected by the contemplated transaction (e.g., in the case of stock purchases and forward or reverse mergers change-of-control or anti-assignment provisions may be triggered).²⁸

The degree of IP and IT interdependence of the Target from seller group entities,²⁹ target group entities³⁰ and third persons³¹ must also be identified and assessed. Depending on the structure of the seller/target group and the business and role of the Target fulfilled in such set-up, interdependence could work both ways (i.e., the Target licenses IP to and/or from seller group entities). In general terms, if the DD identifies that there exists “shared” IP, in carve-outs, the parties must discuss and agree on the future ownership and use of such IP. The outcome of the negotiation and the terms of eventual licensing or assignment arrangements will depend on the bargaining position of the parties. In the case of shared IP:

(i) if, after the completion of the acquisition, the Target would not use IP licensed from seller group entities, the relevant licensing arrangements should be terminated (typically pre-closing);

(ii) if, after the completion of the acquisition the Target would not license IP to seller group entities, the relevant licensing arrangements should be terminated (typically pre-closing);

²⁷ See footnote 12.

²⁸ See footnote 13.

²⁹ That is, those entities that will not belong to the buyer’s group after the effective date of the acquisition (i.e. the entities retained by the sellers).

³⁰ That is, those entities that are being purchased within the framework of the transaction directly or indirectly (e.g., subsidiaries of the Target).

³¹ That is, partners that neither belong to the seller group, nor form part of the target group.

- (iii) if, after the completion of the acquisition, the Target would still be using:
- a) house marks (e.g., the name of the holding company is used by the Target as a product identifier or the Target carries out its business under a trading name that derives from the name of the holding), use could usually be permitted for a limited term;
 - b) trademarks of the seller group, if the goods of the seller group and that of the Target in respect of which the relevant mark is used, are (i) related, the conclusion of a licence arrangement would be necessary, or (ii) unrelated, the parties may find the conclusion of an assignment arrangement beneficial; or
 - c) other IP, the use of such IP should be ensured.³²

Finally, counsel should also gain a clear understanding of the practice of the Target concerning the protection of the Target IP (i.e., whether all Target IP rights are registered, all renewal and maintenance fees are paid when due, which IP right is set to expire in the near future) and obtain confirmation whether there are any ongoing, pending or threatening IP disputes, infringement, unfair competition, misappropriation, and other IP-related claims (e.g., reexamination, cancellation, opposition) involving the Target and the Target IP. In relation to disputes, their materiality, worst and best-case scenarios, alternatives, likelihood of settlement, the costs of dispute should be evaluated by counsel.³³

The issues identified during the DD review, together with their transactional evaluation and IP counsel's recommendation, are summarised in the due diligence report that will be provided to the client for review and consideration. The due diligence report usually has both the IRL and the list of additional questions and requests, together with the sellers' answers submitted in response, as annexes.

VI. CONCLUSION

IP counsel, as an SME, plays an important role throughout the transaction cycle, especially if the Target IP and/or the IP-related interdependence of the Target is material. This involvement should be optimised – on a case-by-case basis, taking into consideration the size and structure of the deal, as well as the materiality of the IP involved – from the perspective, and with the purpose of minimising the acquirer's risk against a lemon purchase.

³² See footnote 12.

³³ Ibid.

It has been demonstrated through the bitter examples of Volkswagen's Rolls-Royce acquisition,³⁴ Clorox's Pinesol purchase³⁵ and Symantex's Bindview acquisition³⁶ that IP due diligence must be taken seriously indeed, especially in cases where "trophy" IP is concerned. IP due diligence, therefore, is not a luxury but a necessity³⁷ and its findings must be evaluated carefully and form the basis of the transaction documents, that – where (and how most) cost-effective – will allocate risk³⁸ through representations, warranties, indemnities, covenants, condition precedents, earn-outs and completion deliverables provisions.

³⁴ M. Lieberstein and G. Peterson, Putting the diligence in intellectual property due diligence: cautionary tales of those who didn't, (2016) 25 (2) *Bright Ideas Newsletter*.

³⁵ R. Cruise, *The importance of due diligence in IP: Lessons from Volkswagen, Apple, Inc. and Clorox Company*, <https://www.pof.com.au/importance-due-diligence-ip-lessons-volkswagen-apple-inc-clorox-company/> (Last accessed: 31 July 2019).

³⁶ T. Lau, *Caveat Emptor: Lessons from Volkswagen's Lemon Purchase*, https://ecommons.udayton.edu/mgt_fac_pub (Last accessed: 31 July 2019).

³⁷ I. Cockburn, *IP Due Diligence – A Necessity, not a Luxury*, https://www.wipo.int/sme/en/documents/ip_due_diligence_fulltext.html (Last accessed: 31 July 2019).

³⁸ J. C. Coates IV, Allocating Risk through Contract, Evidence from M&A and Policy Implications, 09/2012 *Harvard Law School Discussion Paper No. 729*, http://www.law.harvard.edu/programs/olin_center/papers/pdf/Coates_729.pdf (Last accessed: 31 July 2019).

