MAY 2016

DEVOTED TO LEADERS IN THE INTELLECTUAL PROPERTY AND ENTERTAINMENT COMMUNITY

VOLUME 36 • NUMBER 5

THE Licensing Journal

Edited by Gregory J. Battersby and Charles W. Grimes

Wolters Kluwer

Intellectual Property Due Diligence

Suneeth Katarki and Aditi Verma Thakur

Suneeth Katarki is a partner at IndusLaw, India. His work as a corporate and IP counsel spans almost 20 years. He has extensive experience in transactions relating to M&A, PE/VC investments, general corporate advisory as well as consultation on procuring and enforcement of intellectual property rights. Mr. Katarki is a leading individual in the corporate, M&A and PE field by Chambers & Partners in their Asia guides and is an active member of the International Trademark Association. He can be contacted at suneeth.katarki@induslaw.com.

Aditi Verma Thakur is a principal associate at IndusLaw, India. She provides strategic consultation on aspects of selection, registration, management, and enforcement of all types of intellectual property rights, including trademarks, patents, designs and copyrights, in India and internationally. In her career of almost 10 years as an IP attorney, Ms. Thakur has advised multinationals, SMEs, and startups from diverse sectors on various IP issues. She is an active member of the Asian Patent Attorneys Association. She can be contacted at aditi.verma@induslaw.com.

In any corporate transaction involving acquiring a business or a stake therein, the acquirer conducts due diligence of the targets' assets and liabilities, in order to derive comfort that the business is as has been presented to the acquirer and to analyze the risks of the business, as currently conducted. With the help of an appropriate due diligence exercise, the acquirer weighs the assets, liabilities, and potential risks associated with the transaction, analyzes the extent to which any liabilities or risks could be minimized, and finally negotiates the total value for the transaction.

Intellectual property (IP) due diligence is an integral part of the legal due diligence process as often tremendous worth is associated with the intangible assets of the business particularly in contemporary times. Accordingly, IP due diligence involves analyzing the intangible assets of a business, checking valid intellectual property rights subsisting therein and scope of their protection, analyzing the risks involved with respect thereto and in turn, assessing their potential value.

While the target or seller of the business tends to view IP diligence as something that has to be suffered as part of the transaction, it need not necessarily be so. The buyer's findings as a result of an IP due diligence, particularly, if shared or discussed with the seller, give valuable insight to the seller about any gaps in the IP ownership or usage rights. This provides the seller with opportunities for plugging the gaps, further protecting and/or documenting its intangible assets properly as well as mitigating the liabilities and potential risks, if any, in relation to its intellectual properties. All this will be particularly useful knowledge if the transaction does not go through. Even if the transaction does go through, the knowledge will help the seller as such issues often tend to be seen in other businesses being conducted by the seller. It also may be useful to the seller in relation to starting a new business. To a prospective buyer/investor, it gives a holistic understanding of the strength of the target's intellectual properties and the value associated with the same.

Ignoring aspects of intellectual property during the due diligence process can cost a buyer/investor dearly. The Volkswagen-Rolls Royce deal[1] of 1998 should be seen in this regard, where Volkswagen was interested in acquiring the assets of Rolls Royce and owning the brands Rolls Royce and Bentley. Volkswagen acquired the assets of Rolls Royce Motor Cars Ltd for $790 million. The irony of the acquisition deal was, until the closure of the transaction, Volkswagen was not aware that it had merely acquired the factory, facilities, and rights to make and sell Rolls Royce and Bentley vehicles for a period of five years, and also rights to use the marks Bentley and Rolls Royce; and not the ownership over the name and brand Rolls Royce. Apparently, the brand Rolls Royce was owned by parent company, Rolls Royce Plc, by virtue of prior agreements and the parent company was more interested in granting a license and subsequently transferring ownership to a competing group, BMW. After five years from the period of acquisition, BMW became the exclusive right holder of Rolls Royce brand and acquired rights to manufacture Rolls Royce vehicles. By not being careful about assessing the state of intellectual property ownership relating to Rolls Royce, Volkswagen paid superfluous amounts for the returns it received from the deal. This case is one of the best examples (albeit a glaring and extreme one) to show how undermining the role of IP due diligence during a commercial transaction can lead to unprecedented losses to the buyers/investors.

Just as IP due diligence forms an integral part of an M&A transaction, it is equally required for other transactions, for example, joint ventures, investment (PE/VC) transactions, project finance, issuance of new stocks and securities and such. An appropriate IP due diligence helps in setting an agenda for treating relevant IP rights, assessing the risk involved in relation to the target's IP assets and strategizing to resolve the issues.

Every business is different from the other and will have a different set of requirements for analyzing the target's assets and liabilities. However, discussed here are general requirements in an IP due diligence exercise necessary for most corporate transactions.

Identification of Relevant "Protected" and "Protectable" Subject Matters under IP Laws

In all businesses, trademarks and brand names are considered substantial IP rights. If a business is software/technology/product based, its new products, technologies, designs, unique business methods, and such would constitute its principal IP-protectable subject matter. The same would give rise to patent rights, design rights, copyrights and/or trade secrets as its other important IP apart from trademarks. However, in a product-retail business or a service-oriented business, including through e-commerce portals for end customers who are the general public, brand identities become the most important IP.

The first and foremost requirement in the process is to understand the nature of the target's business and to identify intangible subject matters relevant to the business that is the subject matter of the investment or acquisition. The subject matters could be "protected," that is, either by way of registration or by any other recognized means, for example, fixation in a tangible form for copyright accruement or they would be "protectable" under IP laws.

The target would have taken some measures to protect some of its subject matters under IP laws. But it might not have even identified other subjects as protectable. It is for this reason that the first step of IP due diligence is identification of protected and protectable subject matter.

Analysis of IP Rights over the Subject Matter (Status Check)

Once it is clear as to what subjects will be relevant for the transaction, the next requirement is to check the specific IP rights that have been accrued/registered in favor of or are required to be registered by the target. Not only is it important to identify IP-protectable subjects, but it is essential to understand whether such subjects meet the requirements of protection under IP laws.

For instance, a technology could be patented, if it is novel, non-obvious, and industrially applicable. Also, patent rights are not applicable unless registered. New product designs are required to be registered before they are applied to products for commercial sale. Also, a subject matter protectable under patent or design law should not be disclosed to the public until it has applied for registration.

On the other hand, copyrights accrue in literary writings, works of art (logos, designs, website layouts), software codes, database compilations, etc. as soon as such works are fixed in a tangible form. Names and brand identities are protected by way of registration as well as by long, extensive use. Trademark applications/registrations should cover appropriate goods and services.

In relation to protection of know-how and information, there is no statutory law in India that governs and regulates the same. The protection principles have been formulated only under common law (through judicial pronouncements) which place emphasis on showing that the information is indeed secretive or confidential and appropriate contracts and steps have been taken by the business to treat it as such. Hence, steps should be taken to treat and protect significant business information, business methods, pricing, and customer information, as trade secrets and confidential information by way of confidentiality and non-disclosure agreements. If there is no organized manner in which a business organizes and documents its relevant trade secrets, it could lead to trade secret misappropriation.

Owing to the diverse nature of IP protected and protectable subject matter and the rights that accrue therein, it is mandatory to check the applicability of each IP right for every protected and protectable subject matter relevant to the transaction and highlight the intricacies involved therein.

Check for Applicable Territory and Terms (Validity Check)

Most IP rights are valid for limited territories only. With the exception of copyright, one is required to individually protect their intellectual property in all its areas of operation. As per the Berne Convention for the Protection of Literary and Artistic Works, a copyrightable subject matter, if protected in one of the countries of the Berne Union, also is valid in the other member countries. So it is important to scrutinize the particular territories in which the IP rights are protected or applicable. All the relevant jurisdictions in which particular IP rights of the target are protected should be identified. If the target operates in several countries, but does not have its important IPs protected and/or registered in all such jurisdictions, the same could be a big consideration for the prospective buyer/investor, as it could become a major issue in the future.

IP rights are valid for limited periods, except for trademark rights, which can be protected perpetually, or trade secrets, which also can be protected perpetually by maintaining their confidentiality. However, others such as copyrights, patent rights, and design rights are applicable for specific terms. As part of the IP due diligence process, the validity terms of relevant IP rights should be checked. If an important IP's term of protection is over or nearing expiry, the same would be another big consideration for the prospective buyer/investor.

It is noteworthy that the term of protection for an IP right could be slightly different for different territories. So while scrutinizing validity of a protected IP right in a foreign territory, it is important to consider the validity term also. Local IP laws of each jurisdiction will need to be checked for ascertaining the validity term of each IP right.

Check for the Origin of IP Rights Creation (Ownership Check)

One of the most important requirements of an IP due diligence exercise is an ownership check. If the ownership of an IP asset is not vested with the target, it cannot transfer, in any manner, the title, rights, and interests over the same to others. Also, in such case, the use of a particular IP right by the target will be subject to the rights it has received from the actual owner.

If there are many associated parties, such as a parent company, subsidiaries, foreign associate companies, etc., it is possible that the IP is held by the associated units and the target merely has the right to use the same. At times, IP rights holding companies are separately incorporated by corporate groups, with these IP holding companies owning all IP rights and then granting limited rights to all group companies, wherever necessary, for using the IP rights it owns.

Especially in transactions concerning brands as their primary IP, because of the development of the brand by a family owned business over the course of decades, the ownership of IP rights might not be clear or organized. It is quite possible that a well-known brand is co-owned and/or allowed to be used without proper documentation by numerous members of the family. Any kind of transaction in relation to such family-owned brands could be tricky, as the determination of titles and rights in favor of one part of the family would be complicated.

Also, if a subject matter is developed under a work-for-hire arrangement, such as an invention/a software code/a formula/a product design developed by an employee of the target, or a design/a software code/brand identities developed by an independent consultant, such employee or external consultant could be the owner of and/or hold some interests in the IP subsisting therein. In relation to the intangible subject-matters generated by external consultants as well as employees, the target should have taken sufficient steps to have all IP rights therein, if any, to be accruing in its favor.

Unless the ownership of relevant IP rights is exclusively held by/transferred before the transaction to the target, the returns of the buyer/investor so far as they relate to the full use of the same, will indeed be at stake.

Third-Party's Claims on the IP Rights Involved (Claim Check)

The check of third-party claims or interests with respect to the target's relevant IP is required in addition to the ownership check. This is to ascertain if any third party has any rights or interests over the relevant IP. Rights and interests could accrue in favor of a third party unknowingly and unintentionally too. So, scrutiny of all license and franchise agreements, distributorship contracts, joint venture agreements, memorandum of understandings, etc. should be done to identify if any exclusive rights have been granted in relation to relevant IP and also to see if such arrangements are assignable in nature to a prospective buyer/investor.

There also could be encumbrances on particular IP assets if the same have been the subjects of liens. It is not a common practice in India to mortgage IP rights; however, it is possible to do so by law. In order to ascertain if any registered IP assets are subject to any encumbrance, the records of the IP Office concerning the relevant IP in question should be perused. If the target is a company, the records of the Registrar of Companies relating to the target should be perused too. Such checks would reveal details of the applications filed, if any, requesting for recordal of encumbrances on registered IPs or any other IP assets of the target.

Conflicts with Third-Party Intellectual Property Rights (Conflict Check)

A further requirement is to check if the relevant IP rights are in conflict with the intellectual property of third parties. For all important IP rights in question, google searches, searches in international patent, design and trademark databases, searches in the databases of relevant Intellectual Property Offices are advisable.

In case of a new technology, either protectable or protected, in addition to the regular searches, freedom to operate (FTO) searches from patent perspective should be carried out so as to ascertain if the technology could be used and practiced commercially without violating patent rights of third-parties. This exercise gives the prospective buyer/investor knowledge about patent rights of others in relation to same/similar technologies; they can also devise plans, such as taking steps for licensing the third-party patent rights, undertaking invalidity exercises in relation to the same, inventing alternatives for using and practicing the target's technology, and for circumventing the issues that may arise in the future.

In order to effectively comply with the above requirements in an organized manner, these steps should be followed while conducting an IP due diligence exercise.

1. *Set a proper IP due diligence team*—Every legal due diligence team should have intellectual property experts, based on the quantity and nature of target's intangible assets, who should look into all intricacies relating to relevant IP for the transaction; in case the target is technology-heavy, a patent expert from the same domain as the target must be included in the due diligence team.
2. *Prepare and send an IP due diligence checklist*—The first and foremost step of the due diligence exercise is to send out a requisition checklist to the target. This should also contain a checklist of information required to understand the target's business and its existing protected and protectable IP rights; specific questions on registered and pending applications for patent and design rights should be incorporated; additionally, information regarding brand identities, whether registered, applied for, merely used or created should be sought for in order to determine the applicability of copyrights and trademark rights over the same; questions also must be included for seeking details on the proprietorship aspects from the target.
3. *Separate the IP assets of the target relevant to the transaction from irrelevant ones*—At the outset, segregate IP rights or protectable intangible assets relevant for the transaction from those which are not. This should be done as soon as the preliminary perusal of the target's business assets is done. At times, there could be associated and/or supplementary IP rights involved in addition to the main IP rights. The IP due diligence should highlight the importance of connecting such additional IP rights with the main IP rights for the transaction; this will ensure that the focus of due diligence for the transaction is clearly set.
4. *Read all documents carefully*—Read and further read all the documents, whether they are registration documents or agreements in the nature of licensing and franchising agreements, consultancy agreements, technology transfer agreements, as well as other contracts where IP clauses are included, such as joint venture agreements, master services agreements, employment agreements, received from the target from the IP perspective.
5. *Requisition for additional information based on the information*—After understanding the nature of the target's relevant IP assets, and preliminary perusal of the documents and information provided thereby and available generally from its end, further information, documents and clarifications should be sought regarding relevant IP of the target. This should be done with a view to not only verify the already-available information provided by the target, but also to ascertain relevant IP protectable intangible subject matter that could be analyzed further for its potential protection.
6. *Verify facts and confirm information received from the target*—In respect of any information that has been provided by the target, whether at the outset or upon being requested for the same, it is the duty of the due diligence team to verify the same by themselves. In case of contradictory information regarding a particular asset received from the target, going back to the target with a further set of issues and questions must not be avoided at any cost; it is not prudent to merely rely on all details without cross-checking the same from other available sources, such as public records of the IP Offices and the google database.
7. *Analyze protected and protectable IP rights*—After full information is received from the target, IP rights, already subsisting and potential, should be analyzed. Status check, validity check, ownership check, claim check, and conflict check should be conducted, in the manners specified above. In this connection, special attention should be paid to associated licenses, franchise agreements, notices, suit documents, and other documents, if any, relating to the relevant IP rights. If the target's operations are in various countries and information about the target's IP rights in such jurisdictions has

been provided, the team should obtain information either from the online records of foreign IP databases, so far the same are available and accessible, or get in touch with local IP counsels for procuring documents/information on relevant IP rights, registered, or pending registration. Furthermore, for other intangible assets, relevant enquires as mentioned above, should be undertaken for determining the extent of possible protection thereof and risks associated with the same.

8. *Try and resolve issues, if any, in respect of IP rights*—Analyze if any issues surrounding IP rights in question could be resolved. Wherever it is possible, strategize for mitigating the risks involved therein and lessen the liabilities associated with such IP rights. After doing the above, set condition precedents (based on strategies to reduce the issues involved) for the target to comply with in relation to relevant IP rights.
9. *Define the nature of IP agreements required for the transaction*—As for different kinds of transactions, the nature of transfer in relation to relevant IP rights would be differently required; for example, a joint venture would not require complete transfer of ownership of the IP rights to the joint venture company from parties forming the same, but a limited license to use the brand/technology/product designs would be sufficient. On the other hand, an acquisition deal would require an IP assignment or technology transfer agreements. This should be analyzed and determined from the perspective and interest of each party involved in the transaction.
10. *Provide a final diligence report on risks involved*—After all the above steps are taken, put forth the final report containing all the observations in relation to IP rights that would be the part of the transaction, before the prospective buyer/investor. This should contain all the associated risks and liabilities along with strategies to deal with such issues. Also clearly segregate risks and liabilities that could be mitigated from those which cannot be in the report, which will help the prospective buyer/investor understand the pros and cons of the transaction.
11. *Document, execute, and record the IP agreements*—Once it is final as to what approach should be adopted with respect to the relevant IP rights' transfer, the same should be documented in the form of appropriate contracts and executed by authorized signatories at the time of closure of the deal. The new arrangements should be recorded with relevant IP authorities, if required under applicable laws.

Conclusion

The above steps are likely to ensure that utmost care and caution is taken for the required IP due diligence in a simple, but structured manner. The same is required in order to not have fatal returns after spending huge amounts on a business. With the help of an effective IP due diligence, a business call could be taken if it is worthwhile or not to invest in any transaction.

1. Tom Buerkle, "BMW Wrests Rolls-Royce Name Away From VW," (1998), available at *http://www.nytimes.com/1998/07/29/news/29iht-rolls.t.html* (last accessed October 26, 2015); and Adam Liberman, "IP issues in mergers and acquisitions," (2003) available at *http://www.wipo.int/export/sites/www/sme/en/activities/meetings/singapore_03/singapore_liberman_10.pdf* (last accessed October 26, 2015).