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IP due diligence – evaluating a target company's IP assets before agreeing terms in a merger, acquisition or investment

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An IP due diligence process is applicable in many contexts, ranging from mergers and acquisitions to licensing arrangements and venture capital financing. During the IP due diligence an investor, buyer and/or partner makes an investigation into the patents, trademarks, copyrights, trade secrets and other know-how of a target company, in order to identify weaknesses, potential liabilities and potential opportunities.

Verifying all the material facts relevant to the investment or purchase by conducting early IP due diligence is a prudent way to determine the value of business transactions involving IP and, therefore, to avoid or minimize costly mistakes and disappointing outcomes.

While the extent of the due diligence analysis may vary with the amount of money involved, the following discussion outlines some of the issues that may come under consideration and some practical advice for successfully concluding the due diligence process.

Identification

First of all, the target company's current IP portfolio must be identified and categorized. This process should include the dates of application, issuance, expiration, required maintenance payments, and whether foreign IP protection has been obtained.

The target company must also disclose all information about failed attempts to secure IP, including any filings that were rejected, withdrawn or permitted to expire. These filings can in some situations undermine the validity and enforceability of later IP filings.

Investors and buyers should not rely solely on the disclosures from the target company when the IP portfolio is identified. An independent search for undisclosed IP is often necessary. The goal of such a search is to locate pending IP, eg under the name of the inventors, founders, authors or subsidiary names, in addition to the name of the target company.

Thus, a company having IP assets should preferably keep a complete list of all IP filings and all relevant know-how, as this will later assist a potential investor conducting a complete due diligence process.

Relevant IP

It is then relevant to make an accurate description of the technology and/or products that are the focus of the transaction or investment. Such descriptions will inevitability be critical, but it is important to understand and establish how the relevant IP will be used. For instance, will the technology be sub-licensed, used to block competitors from entering specifics markets or simply used to attract other investors? The answers to such questions will enable the IP counsel to determine whether the dominant value lies in the patents, trademarks, copyrights, domain names or know-how, and prioritize accordingly. After all, there is no need to perform due diligence on IP that the target company no longer uses or in which the investor has no interest.

In contrast, IP that is essential for the target companies and/or investor must be afforded meticulous investigation.

Ownership

Ownership is one of the most important issues to explore in the IP due diligence investigation, as only the correct owner is entitled to sell or give licences to the relevant IP.

In this respect it must be kept in mind that many companies 'forget' to register assignments, name changes, licence agreements and/or transfers at the respective authorities and/or patent offices, either in order to keep cost at a minimum or because such registrations are not considered relevant. It is therefore not sufficient during an IP due diligence process simply to rely on the official registers, as the target company may have made other agreements after the IP applications were first filed. Thus, it is important to examine all the target company's licences, material transfer agreements and collaboration agreements, or any other transaction that involves a transfer of IP rights.

Another problem is that some companies draft their own assignments including only vague and/or indefinite statements, eg 'All relevant IP is assigned.' Not only is such assignment impossible to register at the respective patent authorities but, since it can be impossible later to identify which IP assets were actually assigned, the assignment will be subjected to disputes and, in a worst-case scenario, is useless.

An example of the importance of determining the correct owner before closing a deal is that of Volkswagen. In 1998, when it bought Rolls-Royce and Bentley from Vickers, it forgot to confirm the correct ownership of the relevant IP assets. Although VW paid about £430 million for the cars, designs and manufacturing facilities it couldn't use the famous Rolls-Royce trademark, as it had been sold to BMW by the correct owner – Rolls-Royce plc, the aircraft company. Furthermore, it is likely that the price Volkswagen would have been willing to pay for the purchase would have been much lower if the trademark ownership issues had been sorted out before closing the deal.

Thus a company that would like to have the IP assets in good order for a potential investor should make sure that transfers, assignments, name changes and licences are registered with the relevant patent authorities as soon as possible in order to avoid potential confusion of the correct owner.

Inventor

It is also important to ensure that all the correct inventors are mentioned on the patents applications and/or granted patents. Wilfully naming incorrect inventors can be a ground for invalidating patents in, for example, the United States. In this respect, make sure that inventorship decisions are based on facts and not on politics, so that only the correct inventors are listed on a patent application. Many companies have a tendency always to list the managing director or the head of a department as an inventor even though that person has made no contribution to the invention.

Furthermore, all employees involved in the development of new technology should sign contracts in which they automatically assign all rights, including rights to potential inventions, know-how and/or technology. To such agreements should be added conventional assignments where the inventor assigns the right to the specific patent application(s), its patent family and any future filings based on that patent application.

A special note has to be made relating to inventors for US patents. In the United States, patents will be issued in the name of the inventor(s) unless an assignment has been recorded with the United States Patent and Trademark Office. If no agreement exists, eg an agreement where all inventors assign their rights to the company, each inventor owns an equal part of the rights to the US patent. Thus, if multiple inventors are involved and one inventor assigns his or her rights to a company, non-assigning inventors would continue to be joint owners with the company and could, without the consent of the other inventors or the company, grant rights to the patent that would devalue the rights that had been assigned to the company.

Getting inventorship wrong for a US patent can have detrimental consequences for a company, as was the case in Ethicon Inc *v* United States Surgical (Fed Cir 1998). Ethicon had obtained a licence to exploit a patent for a medical device and accordingly sued US Surgical for patent infringement. US Surgical rejected the allegation, stating that the proprietor had omitted the inventor Y J Choi on the issued patent. US Surgical had later obtained a licence from Y J Choi. The court ruled that the inventor was in fact incorrectly omitted and that US Surgical was allowed to practise the invention under the licence agreement.

Thus, if a due diligence investigation reveals that a patent is owned by one or more inventors rather than by the target company, it is necessary to have the inventor(s) assign their rights to the target company before the transaction is completed.

Strength of the portfolio

The IP profile of a company is more than just a portfolio of legal rights to be used as a defensive tool. Accordingly, a strategic review of intellectual property includes considering not only whether the target company is in possession of good IP such as patents and/or trademarks but, more importantly, whether the company has the right ones.

Patents

In respect of patents, three things will generally be considered. Even though the following points primarily are directed at patents, the same principles apply to all IP assets:

1. *Scope of protection.* The essential applications and patents should be evaluated to determine if they sufficiently cover the technology of interest. Unfortunately, it is not uncommon to find that a company's IP portfolio does not adequately protect its main technologies or assets. Such an evaluation includes the following essential assessments:

- An investigation of whether a company's IP portfolio is in agreement with or supports its business objectives and, more specifically, whether it supports the technological competitive advantages associated with current and future profit sources.
- A legal analysis of the relevant patents. The claims determine the scope of the patent, and all aspects of an invention that are not covered by the claims are not considered to be patented. It is important to bear in mind that it is not always easy to determine the scope of a patent, ie the written specification (as the claims are often interpreted in the light of the specification) and the prosecution history (ie the history of the application process). Thus the evaluation aims at forming an opinion interpreting the claims of the patents indicating what, and how well, the patents can reasonably be presumed to protect. The latter includes an analysis to determine whether the problem solved by the patented invention can be solved in any other way. In other words, how likely is it that a competitor could invent around the technical embodiments of the target company's patent?

2. *Geographical extension of the IP portfolio.* Companies generally make strategic decisions about the countries in which they will seek IP protection. In many cases, technologies may be protected in a company's main markets but may be in the public domain in other countries where commercialization is less likely. In the latter countries, a competitor will need no permission (or licence) from the owner to commercialize the product. Thus, it is important to evaluate in which countries applications have been filed and/or if it is still possible to file applications in countries that have a potential market for the technology or product of interest. In this respect, it should be remembered that patent protection is territorial, so the scope of protection for a patent may vary between countries according to national laws and international agreements.
3. *Validity.* It is important to evaluate whether the claims in the applications or patents are in fact valid. In this respect, it can be relevant to conduct prior art searches to confirm the novelty and inventiveness of the claims. Special attention must be paid here to prior publications such as scientific papers, oral presentations or symposiums from the inventors in order to determine if they have made any disclosures of the technology. Such earlier disclosures may deprive the invention of novelty or of an inventive step.

Trademarks

In addition to the general points listed above, the following further points are relevant for trademarks:

1. Determine if the trademarks have been used continuously on the relevant markets and for which goods and/or services the marks have been used. Non-use of specific goods and/or services may invalidate the trademark completely or in part.

2. Determine if the trademarks are used in the same form – and for the same goods and/or services – as they are registered.
3. Determine if the trademarks have been translated correctly for countries using a different alphabet from the original trademark, as a trademark translated improperly will sometimes cause negative effects or even lead to spoilage of the image of the product. As an example, a Chinese mark of the Chinese characters having the meaning of 'White Elephant' would be directly translated into 'Rubbish' using the Western alphabet. Thus, paying attention to the meaning of trademarks is essential.

Freedom to operate

An IP due diligence process also includes the evaluation of other patents that may influence the company's ability to use the patented technology. It is therefore important to point out that there is a clear limit on the extent to which a patent proprietor has the freedom to operate (FTO) or use the patented technology. A patent by itself does not provide the right to commercialize the protected technology but only the right to exclude all others from commercializing it. While the difference may seem subtle, it is a crucial distinction that needs to be made.

Therefore, the investor needs to determine whether it is possible to develop and commercialize the target company's products and technologies. A third party may, for example, have an even broader patent that encompasses the subject matter of the target company's patent.

In general, such an investigation is conducted through an FTO analysis that evaluates whether one company will be able to make, use or sell products without infringing on the IP rights of a third party. An FTO analysis identifies potential legal obstacles, such as valid patent claims of third parties, and therefore informs the investor of potential infringement lawsuits during the due diligence investigation.

How to ensure that an IP portfolio is attractive to a potential investor

Any potential investor or partner will critically evaluate a target company's IP portfolio before deciding whether or not to invest in or partner with the company. While a due diligence investigation may seem invasive for the target company, it should not uncover any surprises if the target company is well prepared.

Based on the above discussion, the following few points can easily (and should) be prepared in advance by any company interested in attracting potential investors and/or buyers – and will ensure that the company's IP portfolio is easier to access and therefore more attractive:

- Have a list of all IP assets, ie patents, trademarks, copyrights, trade secrets and other know-how, that the target company owns or licenses. If applicable, the list should include country of filing, the serial number, the geographical extension and the status of the IP.

- Have a list of all agreements relating to the IP assets, including any assignments, licences, research collaborations and material transfer agreements. Make sure that the agreements refer to the relevant IP assets preferably both by number and by name.
- Make sure that all the correct inventors are listed on the patent application(s) and/or patent(s).
- Make sure that all name changes, assignments, licences and other agreements and other relevant transfers are correct and in good standing and registered at the respective patent offices.
- If possible, carry out your own freedom-to-operate analysis and relevant prior art searches, giving the potential investor and/or partners a good starting point for their investigations.

Conclusion

A complete investigation into a company's IP portfolio can be expensive, yet the cost is typically almost nothing compared to the cost of litigating a patent infringement claim.

Today a company's single most valuable asset is its intellectual property; thus the importance of due diligence in any investment, merger or acquisition decision must not be underestimated. However, it is often seen that, unless the main motivation for the deal is acquisition of IP assets (such as a key patent portfolio or a valuable brand), buyers, investors and/or partners frequently do underestimate the importance of IP due diligence. Accordingly, IP due diligence is often relegated to the end of the checklist and, as a result, is addressed inadequately or in a last-minute manner. Not surprisingly, there are numerous cases in which an oversight in intellectual property matters has caused the buyer's or the seller's position to be seriously compromised. Thus, IP due diligence is necessary to avoid costly mistakes and properly determine the value of business transactions involving IP.