INTELLECTUAL PROPERTY DUE DILIGENCE

[INDUSLAW]

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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 informed 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, analyze the extent to which any liabilities or risks could be minimized, and finally negotiate 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. Findings of a buyer from an IP due diligence, particularly if shared or discussed with the seller, gives valuable insight to the seller on the gaps and lacunae in the IP ownership or usage rights. This provides the seller with opportunities for plugging the gaps, further protecting and/or documenting their intangible assets properly as well as mitigating the liabilities and potential risks, if any, in relation to their intellectual properties. All this will be particularly useful learning if the transaction does not go through. Even if the transaction does go through, the learning will help the seller as such issues often tend to be seen in other businesses being carried on by the seller. It may also be useful to 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 – till 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 5 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 license and subsequently transferring ownership to a competing group, BMW. After 5 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, viz., joint ventures, investment (PE / VC) transactions, project finance, issuance of new stocks and securities and the like. An appropriate IP diligence helps 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, here below are discussed general requirements in an IP due diligence exercise for mostly all 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 the like 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 target's business and identify intangible subject matters relevant to the business that is the subject matter of the investment or acquisition. The subject matters could be 'protected', i.e., 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 favour of or are required to be registered by the target. Not only it is important to identify IP-protectable subjects, but also 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 also 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 public until it is 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)

Next is the requirement to check the term and territory of each applicable IP right subsisting therein.

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 Berne Union, are also valid in the other member countries. So it is also 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 could be protected perpetually, or trade secrets, which could also be protected perpetually by maintaining their confidentiality. However, others like copyrights, patent rights, 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 rights 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 be required to be glanced 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 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.

In case there are many associated parties, like 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 utilize the same. At times, IP rights holding companies are separately incorporated by corporate groups, which IP holding companies own all IP rights and grants limited rights to use to all group companies, wherever necessary, for utilizing the IP rights it owns.

Especially in case of 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 favour of one part of the family would be complicated.

Also, if a subject matter is developed under a work-for-hire arrangement, like 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 favour.

Unless the ownership of relevant IP rights is exclusively held by / transferred before the transaction to the target, returns of buyer / investor so far as they relate to the full utilization 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 favour 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 could also 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)

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 is advisable.

In case of a new technology, either protectable or protected, of the target, 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 device plans, such as taking steps for licensing the third-party patent rights / undertaking invalidity exercises in relation to the same / inventing alternatives for using / practicing the target's technology, for circumventing the issues that may arise in future.

In order to effectively comply with the above requirements in an organized manner, the following 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 must also be included for seeking details on the proprietorship aspects from the target.

(3) Separate the IP assets of the target relevant for the transaction from irrelevant ones – at the outset, segregate IP rights or protectable intangible assets relevant for the transaction from those which are not so; 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, and the like as well as other contracts where IP clauses are included, like 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 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, like, from public records of the IP Offices and 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 also 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 also 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 also be recorded with

relevant IP authorities, if required under applicable laws.

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.

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[1] Tom Buerkle (1998); "BMW Wrests Rolls-Royce Name Away From VW"; available from http://www.nytimes.com/1998/07/29/news/29iht-rolls.t.html (last accessed 26/10/2015); and Adam Liberman (2003); "IP issues in mergers and acquisitions; available from http://www.wipo.int/export/sites/www/sme/en/activities/meetings/singapore_03/singapore_liberman_10.pdf (last accessed 26/10/2015)

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Suneeth has extensive experience in mergers & acquisitions and private equity investment. He also advises clients on joint venture transactions, corporate restructuring transactions, mergers and acquisitions including arrangements amongst shareholders, reduction of capital and complex schemes involving all of the above. Suneeth has been listed as a leading Individual in the Corporate, M&A and Private Equity field by Chambers & Partners in their Asia guides. Suneeth is also a trustee and advisor to charitable foundations and projects, including serving on the Board of United Way, India and United Way, Bangalore.

Suneeth enjoys reading about and experiencing wildlife, likes sports generally but is keenest about chess, cricket, badminton, swimming and scuba diving, loves history and travel and often combines the two.

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Aditi's practice primarily involves advising and strategizing with clients on Intellectual Property protection and management matters. She advises multinationals, SMEs and startups from diverse sectors on various Intellectual Property related issues, including protecting and safeguarding their trademarks, copyrights, patents and designs in India and in foreign jurisdictions. Prior to joining the Firm, she worked with Krishna & Saurastri, Mumbai and Krishnamurthy & Co., Bangalore, where she helped various clients in prosecution and enforcement of their Intellectual Property rights. She has also served as a guest faculty at NALSAR, Hyderabad and GIIP, Bangalore; and contributed to national and international IP journals and magazines. In her spare time, Aditi enjoys watching movies, reading and travelling.

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