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IP risk management to maximise value and success in strategic deal-making

On concluding a corporate IP-related transaction, have you ever second-guessed the deal structure and whether you really optimised value and company success? Enterprise management which is focused on achieving the goals of increasing revenue and optimising profit margins, must involve a keen sense of IP impact to avoid such second-guessing. Recent statistics confirm a global increase in IP litigation due to trends such as 'false marking' lawsuits, directed at commercial products mislabelled with improper patent numbers. The trend towards increased IP litigation illustrates the need for a solid injection of IP savvy into corporate transactions to minimise risk and value a deal accurately.

Re-examination, as discussed in the *IP Value 2010* chapter "Re-examination: a dagger and a shield for impacting on IP value", is but one of the many tools used to enhance the value of an enterprise IP portfolio and/or devalue the IP portfolio of a competitor. The proper assessment of IP assets is crucial to most corporate transactions and requires a comprehensive awareness of subtle IP impact issues, which can dramatically impact on value and success.

The 'IP' in IP impact

Five primary IP rights are often involved in strategic deal-making:

- utility patents;
- trademarks;
- copyrights;
- trade secrets; and
- existing IP agreements

A variety of other IP rights and issues may also impact on a deal, such as design patents, plant patents, semiconductor mask works, unfair competition issues and antitrust issues; however, this chapter focuses on the primary IP categories listed above. Each category covers unique subject matter and differs in duration and legal scope.

IP impact on corporate deal-making

An enterprise engaged in IP-based corporate deal-making as a mechanism for strategic growth must appreciate the subtle risks that each IP asset can possess in order to minimise potential liability. Conversely, a savvy enterprise which engages in a deal involving underutilised, undervalued intellectual property can benefit substantially. For example, where an enterprise uses a target company acquisition to enter a market sector, a past failure of the target to engage adequately in anti-piracy policies can be converted into a substantial windfall through an effective policing protocol. Thus, subtle IP issues can impact on a deal's success.

Patents

Direct and indirect infringement

Patents deemed to have little IP impact on a deal may actually be of key economic value. In contrast, patents purported to be of significant IP impact may be of no value whatsoever. For example, the patent may be invalid, expired or subservient to third-party rights.

Hidden liability for patent infringement remains a significant aspect of due diligence when evaluating strategic growth initiatives. It is an unpleasant surprise when, shortly after closing a deal, an acquiring enterprise receives a patent infringement complaint. Such IP impact issues can be addressed through settlement, as patent litigation is often settled before trial. For example, Sharing Sound LLC recently asserted that it had reached an agreement with Rhapsody International Inc over a US patent entitled "Distribution of musical products by a website vendor over the Internet" following settlement with defendants that included Microsoft and Sony Ericsson Mobile Communications AB. Notwithstanding later settlement, it is preferable to minimise litigation risk through comprehensive due diligence.

A patent owner may also sue those who indirectly infringe a patent through, for example, contributing to or inducing infringement by others. Liability for contributory infringement can exist where one sells a material part of a patented invention, knowing that the part is specially made or adapted for use in patent infringement, and the material part is not a 'staple' article (ie, an article suitable for substantial non-infringing use). Infringement liability can also arise where, for example, there is active inducement of patent infringement by another (eg, where one sells a product with written materials that instruct use of the product in an infringing manner). US law regarding the inducement of infringement fell under the spotlight in October 2010, when the Supreme Court agreed to review the extent to which actual knowledge of a patent by an accused inducer of infringement constitutes an element for establishing inducement.

A patent landscape review can identify potential blocking patents which, from the perspective of the acquiring company, can serve as leverage to reduce the transaction value. Third parties may possess blocking rights that were not previously enforced against a target, but which may be enforced against the acquiring company. Alternatively, a target which can establish that its patent position has been specifically structured to preserve a market position can use this as a selling point to enhance the deal's value. The side of a transaction which most comprehensively assesses intellectual property will be in the best position to exploit the IP impact and optimise the revenue extracted from the deal.

Marking issues

A recent surge in lawsuits filed against companies alleged to have improperly marked products with patent numbers has created a potential liability that cannot be ignored in due diligence investigations. The increasing trend of asserting false patent marking has resulted from a decision of the US Court of Appeals for the Federal Circuit establishing liability as a function of damages per item. When a company has mislabelled a high-volume product with a patent number, the labelling of each product can result in a $500 fine, as well as substantial liability. Comprehensive due diligence must take patent marking issues into account.

Scope of patent claims and coverage of key products

Patents alleged to cover key products must be analysed to ensure market exclusivity. A thorough review entails analysing the patent claims and prosecution history (ie, the records of US Patent and Trademark Office (USPTO) proceedings). Where an amendment or statements against interest were made to distinguish prior art, a claim may possess a more limited scope and be of no value to the deal. Acts of inequitable conduct can also render a patent unenforceable. A limited scope of patent claim coverage and/or unenforceability can hamper the acquiring company's ability to preserve margins and protect market share. In contrast, where the patent's prosecution maximises legal scope, the patent may actually be undervalued by the owner. In such cases, the patent's true value can be used by the target to enhance the deal's value or, if left unappreciated, can be a windfall to the acquiring company. In either case, knowledge regarding the true scope and value of the IP impact can lead to terms which will optimise revenue extractable from a deal.

Ownership

An often-overlooked aspect of due diligence is ownership of the IP rights at stake. For example, a Federal Circuit ruling was recently petitioned to the Supreme Court following a decision that Stanford lacked standing to sue because it never actually acquired an interest in the patents at issue (*Board of Trustees of the Leland Stanford Junior University v Roche Molecular Systems, Inc*). A review will assess whether inventors employed by institutions, whose inventions were conceived or reduced to practice by government-funded research, are entitled to retain and assign rights in those inventions to third parties. Conversely, obtaining a valid licence to a patent does not automatically confer all the owner's rights (eg, legal standing to sue third parties). Specific provisions can be included in a transaction to address ownership issues. However, it is preferable to resolve ownership issues early in negotiation and to agree upon terms for intellectual property unencumbered by liens or security interests.

Trademarks

Comprehensive due diligence of corporate transactions should also include a review of all trademarks, service marks and domain names to ensure that any associated goodwill has been properly protected and exploited in the marketplace. Trademarks must be adequately reviewed to ensure that they correspond to a list of goods on file at the USPTO which reflects the target's market. Proper chain of title to a target must also be confirmed to expose undisclosed security agreements and/or assignments. Domain names should be verified to ensure that they are active and properly titled.

Dilution can significantly undermine the value of a mark and ultimately lead to loss of rights. Any trademark or service mark rights included in a deal should be thoroughly evaluated to ensure that dilution has not occurred.

Appropriate rights to use a third party's mark and/or obligations to honour prior agreements granting third-party rights to use a mark should be carefully vetted. For example, in June 2010 in *In re Exide Technologies* a US federal appeals court held that a corporate transactional agreement transferring trademark rights to a licensee can survive the bankruptcy of the licensor and preclude the licensor from attempts to regain rights to the mark.

Copyrights

Printed materials should be reviewed to ensure preservation of copyright value, including copyrights in the company's website. Online retailers must be aware of the risks that they take in marketing goods which might infringe the copyright of others. Similar liability can occur with bricks-and-mortar outlets. In a recent example, Abercrombie & Fitch Company filed suit against Seena International Inc, a T-shirt supplier to JC Penney Company Inc, asserting that its T-shirts infringed Abercrombie's copyright designs. This case highlights the potential liability that a retailer can assume in a supply transaction. Proper risk assessment in transactions involving the sale, marketing and/or distribution of goods requires that all IP assets be thoroughly analysed.

A significant issue in performing copyright due diligence is appropriate ownership by the conveying party. In *Youngblood v Scorsese* claims and counterclaims have been filed over the copyright ownership of a song recorded by Jimi Hendrix and Lonnie Youngblood in 1969. It is imperative that ownership issues be adequately vetted so that the terms of a transaction properly reflect the property rights which each party brings to the table.

Trade secrets

Proprietary trade secrets must be subject to appropriate safeguarding protocols. Due diligence must be conducted to verify that such protocols exist and are routinely observed.

Trade secret protocols should include, for example, briefing new employees and debriefing departing employees. The absence of such protocols can serve as leverage in assessing the value of trade secrets involved in the transaction. For example, departing employees may improperly disclose trade secret information and render a trade secret useless. Alternatively, employees hired by the target may inadvertently exploit trade secret information of third parties in the development of new products. The absence of trade secret protocols associated with the hiring of new employees and the debriefing of departing employees can create significant liability.

IP agreements

All IP agreements of a transaction for strategic growth, including sub-licence agreements, should be carefully evaluated with regard to substance and compliance. With regard to licence agreements, key provisions include duration, exclusivity, geographic scope, fields of use and the right to sub-license. In addition, clauses directed to warranties and indemnification should be carefully reviewed.

Managing IP impact

When conducting due diligence in corporate transactions involving intellectual property, concerns can be resolved by modifying the terms of the deal – notably, the overall valuation and/or IP infringement indemnification. Alternatively, the following measures can be used to address issues as appropriate.

Patents

Re-examination

As discussed in *IP Value 2010*, re-examination proceedings can be used to address the scope of potential blocking patents (eg, possibly reducing claim scope to avoid a blocking effect). Re-examination may also be used to improve the strength of key patents included in an IP portfolio and/or to expedite settlement of a pending lawsuit.

Reissue

A USPTO reissue proceeding can be used to enhance patent strength. For example, where existing patent claims inadequately cover key products of a party to a deal, a reissue proceeding can be requested by a patent owner to open examination and assert a broader scope of claim coverage protection. Such a reissue must be filed within two years of the patent's grant date. A reissue proceeding can also be used to narrow claim scope at any time during a patent's life to address newly discovered prior art.

Opinion drafting

Where reasonable concern exists that key products may fall within third-party patent rights, legal opinions can be obtained from counsel to assess the risk of infringement. Such opinions must ultimately be found to be legally competent to serve as an effective aid in reducing litigation risk and as a defence against a charge of damage enhancing wilful infringement. Legally competent opinions as to a patent's validity and/or infringement can play a significant role in closing a transaction and preserving value.

Trademarks

Cancellation

Where third-party trademark rights affect a transaction, cancellation proceedings can be explored to remove the mark from the USPTO register in order to ensure that appropriate trademark rights are attributed to the target, and thereby enhance the trademark's value to the overall transaction.

Watch services

A due diligence practice should include a review of efforts taken to preserve key trademark and service marks in the marketplace (eg, to guard against trademark dilution). Trademark watches can be conducted to determine when a potential infringer is using a confusingly similar mark so that such use can be discontinued.

The stronger the protocol that a target has in place for protecting and preserving its marks, the less likely it is that these issues will negatively affect the value of the transaction. The absence of effective procedures can serve as leverage for devaluing the transaction to the favour of the acquiring company.

Copyright

Similar to the watch services noted above, a protocol should be in place to preserve and protect copyrights. The absence of such efforts should trigger heightened scrutiny to any value attributed copyrights in a transaction.

Trade secrets

It is critical that a company which relies on trade secrets to protect its market share and profit margins closely follow its protocols for the preservation of those trade secrets. The lack of adequate protocols should raise a flag. The quicker that protocols are established, the greater the likelihood that valuable trade secret rights will be preserved.

IP agreements

A complete list of all IP agreements should be obtained and reviewed in a due diligence investigation. It may be possible to renegotiate various terms that would otherwise negatively affect a deal. Subtle issues must also be addressed – for example, open source agreements can impose an obligation on the user of open source code to disclose all proprietary code associated with a product developed using any portion of open source code. This can significantly undermine the value of products in the marketplace and pose a significant IP impact. Therefore, all engineering practices of the company being acquired should be reviewed to ensure open source compliance and risk assessment.

Conclusion

The IP impact on strategic growth via corporate transactions can be significant and each IP asset has idiosyncrasies that warrant special consideration in order to optimise risk management and value. A thorough assessment of IP impact can substantially influence a deal's value, and the party with the greater appreciation of subtle IP issues will bear the greatest leverage to maximise value and long-term success.

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