

MERGERS & ACQUISITIONS

Forgot to scrub the IP? Forget the deal

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In recent years, when brokering deals of any importance, the clearance of intellectual property (IP) rights has grown in consequence. IP rights simply cannot be taken lightly. Its importance has grown for a variety of reasons: IP assets have increasingly grown in value; IP rights can act as outright bars to using important brands and technology; and when IP rights are not properly secured, arbitrage opportunities may manifest themselves – particularly with regard to transnational projects.

Increasingly, financial transactions involve investments, business interests and growth opportunities that cross-borders. Although the World Trade Organization (WTO) seeks to help harmonise IP laws throughout its member states via its IP arms (i.e., the WTO's agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) and the World Intellectual Property Organization (WIPO)), most countries' IP laws vary greatly. As such, it becomes difficult to secure IP rights globally. This difficulty often leads to companies limiting the number of regions and the types of IP protections that they secure. The value and growth potential of the underlying IP assets and the extent of the protection sought are factors that are often countervailed against the costs of securing those IP rights.

IP value growth

Intellectual property appreciation rates have sky-rocketed ahead of other assets over the course of the last few decades. For example, in 2002, intangible assets accounted for more than 80 percent of the value of companies comprising the Standard & Poor's index. This was up from around 50 percent in the 1970's. Such increases can be attributed to: increasing licensing revenues derived from IP, the flexibility of IP assets, the general shift from manufacturing to knowledge based economies, as well as myriad other factors.

IP assets have become so central to some companies that they derive most of their revenues from IP rights. For example, as of 1992, Texas Instruments, Inc. (TI) generated more from IP licensing revenues than it did from general operating revenues. Since then, TI has gone on to enjoy even greater profitability from licensing its IP. And TI is not alone.

Another more colourful example regarding the Coca-Cola trademark illustrates that IP asset values are malleable and lend themselves to manipulation for the benefit of the asset owner. In 1998, the general counsel for Coca-Cola gave a talk at Franklin Pierce Law Center where he noted that if every single tangible asset owned by Coca-Cola simultaneously burned to the ground, Coca-Cola could easily obtain lines-of-credit for over \$60bn to rebuild the company based solely on the value of the Coca-Cola

trademark. This anecdote has since been revised; the estimates for credit lines for the Coca-Cola trademark have been upped to \$150bn even while Coca-Cola's entire market capitalisation is hovering at around \$103bn. Interestingly, if you looked at the company's balance sheets, it reported trademark values of significantly less, i.e., around \$2bn.

Finally, although there are other reasons for the increased value of IP assets, chief among them is the worldwide shift from manufacturing and industrial economies to service and knowledge based economies, which rely more heavily on intangible assets. Over the course of the last few decades, this shift and growing legislation implementing strong IP laws throughout the world have allowed the producers of IP assets to erect significant barriers to entry against competitors. It has also caused an increase in the number of filings for IP rights, globally.

IP rights as barrier to entry

Perhaps the ultimate advantage in business is the ability to keep competitors at bay. That is one reason why having a monopoly is so coveted. It allows you to exclude others from competing. IP laws provide limited monopolies to the owners of IP assets. This ability to exclude is so critical in some cases, that it can make or break a company. In 1999, Amazon.com, Inc. was able to exploit its now infamous (and still valid) one-click patent to prevent its much larger (at the time) competitor, Barnesandnoble.com, Inc. by enjoining it from competing in what was widely considered to be the first major "e-Christmas". The timing of the injunction could not have been much better for Amazon. Although Barnes & Noble survived, Amazon thrived when it otherwise may have been bowled over by Barnes & Noble.

With injunctions, the potential for catastrophe is significant. For example, there are now many patents filed in the financial services sector that are directed to electronic trading systems. These trading systems are responsible for billions of dollars worth of trades per day. If forced to honour an injunction that causes the close of a trading system, the harm a competitor would suffer could be terminal.

Lack of IP law uniformity allows for arbitrage

Although IP laws are not uniform throughout the globe, the IP rights you might enjoy in one country may well be affected by your rights (or lack thereof) elsewhere. Perhaps the most straightforward and current effects of IP arbitrage may be demonstrated with the US Digital Millennium Copyright Act (DMCA). Apple computer em- ►►

employs a type of Digital Rights Management (DRM) called Fair-play to protect music it sells via the iTunes Music Store from being copied to more than five computers. A program called Hymn was developed to strip this DRM from the file, which then allows the iTunes music to be loaded and played on an unlimited number of computers. Hymn was initially stored on US computer servers, but after Apple sent cease-and-desist letters, the program was transferred to servers in India where it has been regularly updated and apparently escapes the reach of Apple and the DMCA.

Such disparities in the implementation of IP laws cause software development to move to governments that provide safe havens and/or opportunities to work around the IP holder's rights. Of course competitors may seek arbitrage opportunities under more simple circumstances as well. If a patent holder obtains patent protection in just one country, then competitors will be free to exploit that patented technology elsewhere throughout the globe.

Due diligence to the rescue

The great value of IP rights and the difficulty in effectively implementing and exploiting those rights on an international scale presents a great number of difficulties and lessons for the financier. On the one hand, the IP assets may be key barriers to entry that provide the underlying basis for engaging in an acquisition and/or investment. On the other hand, these IP rights are rather fragile and may be circumvented either through arbitrage opportunities and/or through defects in the development of the IP. As such, due diligence review of IP assets involved in a transaction becomes a critical task in identifying and avoiding such risks.

Due diligence investigations generally amount to employing IP attorneys to identify and then review a target company's IP assets thoroughly and provide the financier with a report of potential problems, defects and

opportunities regarding that company's IP. In some cases, the IP attorneys' recommendations may dictate whether or not to engage in the transaction. The due diligence process is relatively involved, intricate and tailored to the particular facts surrounding a given acquisition and/or investment opportunity. However, it usually will involve evaluating the substantive strength and formal validity of various IP rights and agreements held by the target company.

This may involve reviewing technology transfer and employment agreements to make sure various rights and/or indemnities are not shared or that exposure to IP litigation is not an overly large risk. Another aspect of the diligence review is to determine if in fact IP rights are owned by the target company and are being transferred appropriately. During a diligence review, it is not unusual to come upon target companies that either did not actually own, or unwittingly may have given away key pieces of IP due to some formality defect. For example, this may occur when former employees failed to assign their IP rights or if there was no employment agreement in place with an obligation to assign the rights to the target company. The result is that the ex-employee might be a co-owner in the IP assets. On other occasions one may discover that the structure of various transfers may actually destroy a valuable IP asset. For example, if a target company licenses a trademark as part of an asset sale and there are no provisions for quality controls over the mark, then that trademark may become invalid because US law considers such "naked licenses" to be ineffective.

A relatively intriguing example of an asset acquisition gone bad involved Rolls Royce. In 1998, both BMW and Volkswagen were interested in buying Rolls Royce. Volkswagen *thought* it purchased Rolls Royce after it quickly won with a bid of \$795m. However, Volkswagen forgot to investigate if trademarks were part of the deal. They were not. And in fact, the trademarks were sold to its bidding *rival*, BMW, for \$65m. Apparently, Volkswagen bought the manufacturing and production assets, but not the famous trademark. Clearly, selling a Rolls without its famous trademarked hood ornament and name would result in a colossal venture failure. Eventually Volkswagen obtained the Rolls Royce mark and BMW obtained the Bently trademark; but only after they battled it out in court.

Needless to say, there are many opportunities for mishandling and/or overlooking some critical information regarding IP. The consequences for failing to identify problems with IP can be dire. IP due diligence reviews performed by competent IP counsel should bring to light most (if not all of) the many "gotchyas" that may sour a deal. As a result, IP due diligence investigations have fast become routine and standard practice for those engaging in financing transactions. ■

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