INTELLECTUAL PROPERTY IN M&A TRANSACTIONS AND INVESTMENTS:

THE IMPORTANCE OF EFFECTIVE IP DUE DILIGENCE

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Intellectual Property (IP) is often a key driver of mergers and acquisitions (M&A) and investments involving technology-focused companies. Important considerations for the purchaser/investor to take into account are the value and importance of the target's IP relative to its competitive position in the marketplace and the risk of patent infringement lawsuits being filed against the target company after the close of the acquisition/investment. IP due diligence is a critical tool in evaluating the target's IP in the proposed transaction and the IP risks in proceeding with the acquisition or investment. A review of the scope of the target's IP enables the buyer/investor to evaluate the risk that the target does not possess sufficient IP rights to prevent competitors from eroding the target's market share. Similarly, comprehensive IP due diligence includes an evaluation of IP owned by third parties to determine IP risks associated with the sale of the target's product(s).

If significant risks are identified, effective IP due diligence can identify avenues for curing the identified risks pre- or post-transaction. Where risks cannot be cured, IP due diligence allows the buyer to propose appropriate mitigations, representations, warranties and indemnifications in the transaction documents to get comfort going forward with the transaction. Understanding the scope of the target's IP assets and IP risks to the target's business can be the difference between a successful transaction and one that becomes a source of frustration. Discussed below are some general considerations to take into account when conducting IP due diligence in technology-focused companies.

Analysing title to IP assets

One of the most important aspects of an IP due diligence review is ensuring that the target has good and valid title to its IP. The United States Patent and Trademark Office ("USPTO") maintains an official record of the current title holder of both patents and trademarks. Searching these "assignment databases" is a crucial step in ensuring that the target's representations regarding IP ownership are accurate. The title chain for all IP assets should be reviewed to ensure that:

- any transfers or changes in ownership are clearly reflected in the official record;
- there are no unexpected exclusive or non-exclusive licenses of the IP assets granted to third parties; and
- there are no unexpected encumbrances, such as liens and security interests, that may restrict the transfer of title to the IP assets.

Where the relevant database does not reflect that the target owns, or fully owns, the title to the IP assets, it may become necessary to investigate why there is a break in the title chain. Where the gap arises from corporate name changes or prior mergers, chain of title issues often can be cured. However, where the break in title occurs due to failure to obtain assignments, such as from all the named inventors on a patent, it may be necessary to require the target to secure the necessary IP rights prior to the transaction closing.

Using patent scope analysis

The claims of a patent define the scope of coverage of the patent. While a patent application may start out with broad claims directed to a specific technology, the process of obtaining a patent usually involves narrowing the scope of the claims to avoid overlapping with existing inventions. As a result of this narrowing process, the granted claims may no longer cover the key features of the commercialised product(s). IP due diligence looks at the claims of the target company's patents and compares them to the company's commercial products or services. For example, if the target company's patents are directed to pharmaceutical products, the claims are evaluated to ensure that the claimed formulation or composition is the same as that used in the commercialised product.

Even when IP due diligence determines that the patents owned by the target cover the product, IP due diligence should also assess the risk that those patents can be designed around. Where patents call for specific ranges, components, or configurations that are not critical to the commercial product, a competitor could sell a product that escapes the scope of the patent. Here, IP due diligence informs the buyer/investor of this business risk, and provides options to mitigate them. For example, the buyer can require the target to alter or amend existing patent filings or file for new patents more aligned with the commercial product.

Dependence on third-party IP

Another important aspect of IP due diligence is to evaluate any in-licensed IP. Where the licensed IP is critical to the commercialisation of the target's product, the scope, duration and exclusivity of the licensed IP needs to be evaluated. Likewise, the terms of the license, such as if it is assignable to a third party, and any particular restrictions on the use of the licensed IP, need to be evaluated as part of the IP due diligence process. Where risks arise, the target can be asked to renegotiate or otherwise modify the terms of the IP license to minimise the IP risks.

Utilising freedom to operate studies

One way to gain insight into the risk represented by the target's current commercial activities is to conduct freedom to operate (FTO) studies. A search of U.S. and/or foreign patent databases can be conducted or commissioned to identify those live and enforceable patents that have claims that could potentially be asserted against the target's products. These searches look to determine whether there are patents that pose an infringement risk (i.e., there is at least one patent claim where each element is found in the target's products). Some of the factors that go into evaluating the risk posed by third-party patents are:

- Who owns the patent?
- Is the patent owner a direct competitor of the target company?
- Is the patent owner a large or small company?
- How litigious is the patent owner?
- Has the patent been asserted in litigation against any third parties?
- Do companies in the target company's industry often litigate patent disputes?
- Is the patent likely to survive patentability challenges?
- Has the validity of the patent been challenged in court or the USPTO?
- How long have the target company's products been in the marketplace?

For the most problematic patents, after taking all of the various factors into consideration, diligence counsel should reach an educated conclusion as to: (i) the likelihood that the patent owners would assert their patents against the target company; and (ii) the strength of the target company's defences to any patent infringement claims asserted.

Analysing litigation risks

In some situations, the target company has already engaged in IP litigation, or is currently a party to an on-going IP litigation. When the target company is a defendant in a pending litigation, additional information is available to aid in an evaluation of the merits of the lawsuit. At a minimum, diligence counsel should carefully review:

- Court pleadings and related documents;
- The asserted patents and their file histories;
- Technical documents relating to the target company's products;
- The litigation history of the asserted patents;
- Chain of title documents; and
- Information about the judge assigned to the case including prior decisions in similar cases.

Based on a review of the foregoing documents and information, diligence counsel can make determinations with respect to possible adverse outcomes, the strength of the patent claims, and possible defences.

In addition, it is important for diligence counsel to understand how any prior IP dispute was resolved. If the target was involved in a prior IP dispute and there was a settlement, settlement documents should be scrutinised to determine what obligations survive and may have an impact on future business plans. For example, a settlement may include a cross-license to particular technology in a specific field or geographic area.

Conclusion

IP due diligence is a valuable part of the M&A transaction toolkit and can be used to assist the buyer/investor in evaluating the economic value of the IP assets of the target. Detailed assessments of the strength, scope, limitations and quality of the target's IP can be used to understand how the IP aligns with the buyer's/investor's business objectives and goals.

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With a litigator's perspective, Yuval also conducts IP due diligence on behalf of investors and companies relating to investments and M&A transactions (totaling more than $1 billion), including in connection with life sciences and medical technology companies. Yuval helps buy-side clients evaluate and understand the IP litigation risks inherent in each investment or acquisition opportunity.

Yuval frequently lectures and publishes articles on many intellectual property topics and has been selected to the New York Metro Super Lawyers in the category of Intellectual Property Litigation from 2011 to the present and in 2022 was also selected as one of the top 25 Super Lawyers in Westchester County. He has also been recognized by World Trademark Review and IAM Magazine, most recently in the 2022 WTR 1000 and the 2022 IAM Patent 1000.

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Jordan conducts IP due diligence on behalf of investors and companies relating to investments, debt and alternative financing arrangements and M&A transactions (totaling more than $1 billion), including in connection with life sciences and medical technology companies. Utilising his hands-on patent prosecution experience, Jordan enables clients to evaluate and understand the scope and strength of the patents and other IP assets that form the basis for the investment or acquisition opportunity.
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