

An Evolving Market: Key IP Issues for M&A Transactions

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Overview: What is IP and Why is it Important in M&A Deals?



What Is Intellectual Property?

OVERVIEW: WHAT IS IP AND WHY IS IT IMPORTANT IN M&A DEALS?

- Conventional categories of IP:
 - Patents, copyrights, trademarks and trade secrets
- IP continues to evolve and now includes certain other types of assets.
 - E.g., domain names, social media identifiers, rights of publicity, design rights, database rights
- Unlike tangible assets, IP is **highly divisible and non-rivalrous** – i.e., multiple people can use it at once without any additional cost to the owner.
- The fundamental economic benefit of an IP right is the **right to exclude**.
 - IP rights can grant a person the power to exclude others with respect to a particular invention, work or brand.
 - For certain companies, this can be critical to their ability to maintain or expand market share (e.g., drug companies, movie studios, fashion designers, consumer product companies).
- The **right to practice** (not necessarily at the exclusion of others) can be equally critical. Without the **freedom to operate**, a company can be enjoined from valuable lines of business which are critical to its bottom line.

Key Types of IP Assets

OVERVIEW: WHAT IS IP AND WHY IS IT IMPORTANT IN M&A DEALS?

Patents:

- Protect **new, useful and non-obvious inventions**
- Owner has the right to exclude others from practicing the claimed invention (but not necessarily to practice their own invention)

Copyrights:

- Protect **original works of authorship** which are fixed in a tangible medium
- Only **expression** is copyrightable (not facts, functions or ideas)
- Limited protection for software

Trademarks:

- Protect **badges of origin** (i.e., words, names, symbols or devices)
- Granted for a **particular field of use**, although “famous marks” are afforded broader protection
- Strongest trademarks are **invented** (e.g., “Kodak”), and not suggestive or descriptive

Trade Secrets:

- Protect “secret” information which has value because it is **not generally known** (e.g., manufacturing processes, secret recipes, source code)
- Hard to “schedule” and most companies do not keep a database

Other Types of IP Assets / What Is Not IP?

OVERVIEW: WHAT IS IP AND WHY IS IT IMPORTANT IN M&A DEALS?

- Other types of IP assets:
 - **Rights of publicity or personality**
 - E.g., name, image, likeness or other unequivocal identifiers, such as voice or signature
 - In the U.S., protection varies from state to state, and internationally there are varying degrees of protection.
 - **Database rights**
 - Comparable to copyright, but distinct because recognizes the investment that is made in compiling a database, even when it does not involve “creative” effort as required by copyright
 - Not a distinct IP right in the U.S; only protected as a copyright or trade secret
 - **Design rights**
 - Typically protects the ornamental shape of a product (i.e., how a product looks)
 - In the U.S., protected under patent law as a “design patent”
- What is **not** considered IP in the U.S.:
 - Raw data (e.g., the phone book)
 - Fashion designs (although some countries like France offer strong protections)
 - Anything in the public domain (e.g., anything covered by an expired patent or copyright)

Why Is IP Important in M&A Deals?

OVERVIEW: WHAT IS IP AND WHY IS IT IMPORTANT IN M&A DEALS?

- For many companies, IP is the asset class that is **fundamental to their value**.
- Unlocking the value of a target's IP can represent the principal basis for an M&A transaction and is a key driver of M&A activity.
- A target's business can be dependent on IP in any number of ways. IP can be shared across different business units within a company and across multiple jurisdictions.
- The determination of "what goes where" is not binary, and from a deal perspective, IP can be **sliced and diced** to achieve the commercial objectives of the parties.
- The cross-border implications of the deal need to be taken into account in the allocation of IP rights between buyer and seller.
- Defining which party to a transaction has **the right to practice** a particular IP asset and which party has **the right to exclude** are fundamental.
- Maximizing value requires a clear understanding of each party's commercial objectives with respect to IP and, in particular, whether a party is more concerned about its freedom to operate or its right to the IP portfolio as creating a meaningful barrier to entry for its competitors.

Key IP Concerns of Buyers and Sellers in M&A Deals

OVERVIEW: WHAT IS IP AND WHY IS IT IMPORTANT IN M&A DEALS?

- Buyer is principally concerned with ensuring that:
 - It acquires exclusive, unencumbered and marketable title and/or a valid license to all of seller's IP necessary to exploit the divested business or assets
 - The purchased/licensed IP is valid and enforceable
 - There are no challenges to the purchased/licensed IP
 - There are no actual or threatened claims of infringement, misappropriation or other violations of third-party IP
 - It will enjoy freedom to operate with respect to the divested business or assets
- Seller is principally concerned with ensuring that:
 - It does not assume the risk for IP matters for which there are inherent unknown risks (e.g., freedom to operate, validity and enforceability of IP)
 - IP assets of seller which are not part of the transaction are not unnecessarily encumbered by the transaction
 - It is not providing any assurance for third-party IP matters which seller does not control (e.g., the inability to ensure that IP licensed from third parties will be made available to buyer on the same or similar terms as enjoyed by seller)

IP-Related Due Diligence



General Objectives of IP Due Diligence

IP-RELATED DUE DILIGENCE

- Assess the target's **IP assets**:
 - Consider the geographic and substantive breadth of the **registered IP portfolio**.
 - Identify any chain of title issues related thereto and any gaps in protection.
 - Think about the context and what is likely to be important.
 - E.g., in a pharmaceutical deal: (i) Does the target have a composition of matter patent for a key drug? (ii) Does the target have a registered trademark and domain name for the brand of the drug across the relevant jurisdictions? (iii) Are there any validity or enforceability issues?
 - Understand the importance of forms of **unregistered IP** (e.g., trade secrets, proprietary software, data) to the business.
 - Identify any clouds on the target's title with respect to unregistered IP.
 - Consider any failures or lack of internal controls to preserve confidentiality.
 - Assess whether open source is an issue and, if so, whether a software audit should be conducted to assess the risk.
 - Consider the target's **dependency on third-party IP**:
 - Think about deal structure.
 - Will any in-licensed IP be vulnerable due to any anti-assignment and/or change of control provisions?
 - To what extent will the scope of any third-party licenses extend to the combined business?
 - Consider **potential IP exposure**:
 - Any IP litigation or disputes, validity or ownership issues, licenses and other encumbrances?
 - Assess whether the target has indemnification or insurance protection in respect of such exposure.
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Roadmap for IP Diligence – Key Questions

IP-RELATED DUE DILIGENCE

- What kind of products or services does the target provide and in which jurisdictions?
- Which IP rights might be implicated by the sale of those products and services and where?
- How important is registered IP to the target's business?
- How important are other forms of IP to the target's business?
- Is any IP licensed from third parties material to the target's business?
- Is the target a software company?
 - If so, consider potential open source issues.
 - Does the target deposit source code into escrow?
- Does the target's industry have any significant IP litigation?
- Which types of data does the target store? How and where does it store such data?
- Are broad IP cross-licenses standard in the target's industry? If so, to what extent are the target's IP assets already encumbered by cross-licenses?
- Would any of the target's licensing obligations implicate IP of buyer or its affiliates?
- Will any of the IP and/or technology of seller be required by buyer post-closing?
- Will seller require access to any IP and/or technology of the divested business post-closing?
- Will transition services be required?

IP Diligence Materials

IP-RELATED DUE DILIGENCE

- Early-stage, publicly available information:
 - SEC filings (including material contracts)
 - The target's and its competitors' websites
 - News articles and publications
 - Information on adversarial proceedings (if any):
 - Litigation pleadings, briefs and decisions
 - USPTO proceedings
 - Publicly available information from the USPTO and USCO (e.g., patent titles and abstracts, assignment recordation, trademark classes)
- Materials and information provided by the target:
 - IP licenses and other IP-related agreements and documents
 - Additional information related to any IP litigation, proceedings or disputes
 - Lists and descriptions of registered and unregistered IP
 - Access to personnel and legal counsel
 - Ask the hard questions
 - Hold their feet to the fire!

IP Diligence Report and Follow-up

IP-RELATED DUE DILIGENCE

- Highlight IP issues, risks and **potential show-stoppers**:
 - Identify anything that may affect value (e.g., key software that may be released from escrow to a competitor by virtue of the transaction, a challenge to a key patent, a major claim of patent infringement).
 - Consider what, if anything, may require special consideration in drafting and negotiating the purchase agreement and ancillary documents (such as a special indemnity).
- Consider what needs to be dealt with **post-signing and/or post-closing**:
 - Obtaining consents of counterparties (and consider whether any should be a condition to closing)
 - Coordinating filings with the USPTO, USCO, foreign IP offices and other registrars
 - Releasing encumbrances
 - Transitional licenses or other arrangements (e.g., cross-licenses, branding phase-outs, IT transition services, manufacture/supply agreements)

IP-Specific Provisions of Transaction Documentation



IP Representations and Warranties

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- IP representations and warranties **should never be reviewed in a vacuum**. They live and breathe with the other provisions of the purchase agreement. It is also important to understand that it is **not** a “**one size fits all**” approach.
- **Consider deal structure** as it will inform approach:
 - Public vs. private
 - Financial vs. strategic buyer
 - Availability of representation and warranty insurance
 - Limitations on the availability of indemnification protection (e.g., is materiality being read out for purposes of the indemnity?)
- Are there more generalized representations and warranties that may provide adequate protection (e.g., general sufficiency of assets)?
- Depending on the target’s industry/business, certain **additional representations and warranties** may be appropriate (e.g., membership in industry standard bodies, use of government funding).
- Should any IP representations and warranties be treated as “fundamental”? Do any require special treatment?
 - E.g., in the pharmaceutical context, buyer may seek **extended survival periods and/or special recourse** (e.g., earn-outs/milestone set-offs) if any divested products are still in development, so that the representations and warranties will provide protection upon commercial launch.

IP Representations and Warranties (cont.)

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- ✓ Schedules of registered IP and material IP agreements
- ✓ Sufficiency of IP rights
- ✓ Ownership and title to IP
- ✓ Validity, enforceability and maintenance of IP
- ✓ Non-infringement of third-party IP rights
- ✓ Non-infringement of target IP by third parties
- ✓ No pending or threatened IP claims or proceedings
- ✓ Trade secret protection
- ✓ Employee/contractor IP invention assignment
- ✓ Sufficiency, operation and protection of IT assets
- ✓ No software defects or malicious code
- ✓ Open source software/redistribution obligations
- ✓ Compliance with data privacy and security-related obligations
- ✓ No data or security breaches or unauthorized access to IT systems

IP Covenants

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- IP-specific **interim operating** covenants:

- Buyer may seek to place restrictions on the sale and licensing of IP, and/or to require seller to maintain, protect and enforce such IP, between signing and closing.
- It is customary for seller to accept such restrictions, given they permit immaterial exceptions or other exceptions that arise in the ordinary course of seller's business (e.g., abandonment of IP no longer useful to the business).

- IP-specific **post-closing** covenants:

- Buyer may seek a limited license to use seller's trademarks with respect to the divested business or assets until re-registration in buyer's name is completed and/or existing inventory is exhausted.
 - It is customary for seller to grant such rights so long as the time period is reasonable and buyer agrees to be subject to quality control obligations.
 - Duration can be divided based on specific uses.
 - Note: Seller may request indemnification for post-closing trademark use.
- Depending on diligence findings, buyer may also seek that seller correct any defects in the chain of title, obtain IP-related consents and/or enter into confirmatory IP assignment agreements.

Carve-out Transactions

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- While IP issues can be of primary importance in virtually any type of corporate transaction, whether public or private, certain types of transactions typically see IP issues at the forefront.
- IP issues are specifically prevalent in carve-out transactions, i.e., any sale by a company of a portion of its business.
 - This could be a sale of one or more product lines, divisions, subsidiaries, etc.
- Key IP concerns in carve-out transactions:
 - IP assets often have significance and value for both buyer and seller. Consideration must be given as to **how to allocate and share such IP assets.**
 - Note: The “scrambled egg” problem (especially in the case of software and other IT)
 - Seller’s IP protection for the business may depend on company-wide relationships (e.g., portfolio cross-licenses, defensive capabilities, supplier/customer relationships) that buyer will not inherit.
 - Will buyer have the same freedom to practice all necessary IP that seller has with respect to the business?
 - Will buyer have the same power to exclude competitors/adversaries as seller has with respect to the business?

Structuring the Deal: IP Ownership

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- The threshold issue in carve-outs concerns defining **which IP assets are included in the sale**, i.e., IP set forth on schedules vs. IP “[*primarily/exclusively*] used in the business.”
 - Note: Nominal “ownership” of IP often has mystique and psychological weight in negotiations.
 - In reality, IP is a bundle of rights.
 - These rights can be “sliced and diced” in a myriad of ways via a license agreement.
 - “Owners” only have rights to the extent the license agreement does not provide otherwise.
 - Do not focus on nominal title; instead pay attention to the underlying rights.
 - In allocating ownership of IP assets, consider:
 - Where each asset will serve the highest and best value; and
 - Defensive and offensive leverage.
 - A spin-off needs relevant protection and leverage.
 - E.g., IBM has a proven, effective patent licensing program.
 - In general, the goal is to **avoid post-transaction entanglement** between buyer and seller.
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Structuring the Deal: Shared IP Rights

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION

- If buyer and seller both need rights to certain IP post-closing, this can be addressed through a **cross-license agreement**.
 - The key threshold question is whether the cross-license is intended to provide non-exclusive freedom to operate to each party or, alternatively, to provide either party with exclusivity and control over the licensed IP.
- Aspects of cross-license agreements that are often **highly negotiated** include:
 - **Scope of IP** included in the license granted to each party;
 - Existing IP vs. improvements
 - Defined list vs. defined by reference to transferred business/assets
 - **Scope of license** granted to each party (e.g., licensed fields, products, territories);
 - Scope and duration of any **exclusivity** granted to each party;
 - Can be a license back to seller outside of buyer's field or an exclusive license to buyer within buyer's field. Partially depends on existence and scope of any out-licenses
 - Allocation of responsibility for IP maintenance and enforcement; and
 - Restrictions on transferability and sublicensability of rights.
- Note: The approach taken with respect to these issues is unique to each transaction and the parties' respective commercial goals.

IP-Related Ancillary Agreements

IP-SPECIFIC PROVISIONS OF TRANSACTION DOCUMENTATION



IP Assignment Agreements

- May be necessary in order to transfer IP from seller to buyer in an asset sale or carve-out



Trademark Licenses

- When more than a temporary and transitional use of seller's trademarks is contemplated, the parties may enter into a stand-alone trademark license agreement that contains more robust quality control and protective provisions than would be included in a transaction agreement.



IP Cross-licenses

- When IP is being shared between buyer and seller post-closing (e.g., in carve-out transactions)
- May cover patents, software, know-how or other IP or technology



Commercial Agreements

- E.g., supply, manufacture, reseller, distribution, escrow
- If the transaction contemplates a go-forward commercial relationship between buyer and seller post-closing
- This is common when seller previously relied on intercompany agreements or informal arrangements to receive certain products or services prior to the transaction.



Transition Services Agreements

- If the target was heavily dependent on or intertwined with seller's retained business, the parties may enter into a TSA whereby seller will provide certain services to the target for a limited time period.

Data Protection and Privacy



How Data Privacy and Cybersecurity Obligations Affect M&A Transactions

DATA PROTECTION AND PRIVACY

Target Valuation

- Potential civil and regulatory liability from **undisclosed cyber breaches** or data privacy violations
- **Business model** dependent on practices that violate privacy and cybersecurity regulations (e.g., could the target's business be regulated out of existence?)
- Nature of data collected results in costly **regulatory compliance obligations** (e.g., GDPR, CCPA, HIPAA)

Target Characteristics

- **Importance of data** (personal or otherwise) to the target's business
- **Types of data collected** or used (e.g., PCI, SSNs, highly sensitive information)
- **Consumer focused** vs. business to business
- **Geographic footprint** (extent of operations in the EU and other jurisdictions / transfers abroad)
- **Heavily regulated** component of the target's business (e.g., healthcare, financial services)

Relevance for Cross-Border Transactions

- **Personal data may be transferred** outside of the EU as part of the transaction
- Such transfers **require the implementation of specific protections** under the GDPR
- Consider the extent necessary to share personal data as part of the M&A process

Transaction Agreements, Risk Allocation and Closing / Post-Closing

DATA PROTECTION AND PRIVACY



Reps and Warranties

- Definitions of “Personal Data” / “Personal Information” must be broad enough to **cover the GDPR’s and the CCPA’s expanded breadth**
- **Compliance with more than “Law”** (e.g., policies, contractual obligations)
- Appropriate information security program
- **No breaches, exfiltrations or unauthorized uses** of Personal Data
- No breach notification obligations or notifications made
- No claims, investigations or complaints
- No restriction on transfers



Risk Allocation

- Consider adequacy of representation and warranty **indemnity survival periods** and **limitations on liability**
- Consider **special indemnities** for any known issues
- Consider whether data privacy and cybersecurity issues can be **excluded liabilities** (e.g., due to constantly shifting regulatory landscape)
- If utilizing **representation and warranty insurance**, check if data privacy and cybersecurity are excluded (but trends yet to be seen)



Closing / Post-Closing

- **Transfer of target data** as part of closing **must be lawful** under the GDPR
- Transfer of target data outside of the EU requires **appropriate legal basis**
- Transition services agreements involving personal data must meet controller-processor **contractual requirements** or controller-controller obligations
- Buyer’s planned use of the data may not be permitted without updated, affirmative **consents** from, or **notifications** to, relevant data subjects
- New or **expanded regulatory compliance function**

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