MERGERS & ACQUISITIONS IX: INTELLECTUAL PROPERTY ISSUES: DEAL POINTS

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I. Executive Summary

This is the ninth in our series of advisories on Mergers & Acquisitions ("M&A"). Its predecessors in the series, "Mergers & Acquisitions I: Overview and Transaction Types" ("M&A I"), "Mergers & Acquisitions II: Tax Structuring Considerations" ("M&A II"), "Mergers & Acquisitions III: Acquisition Consideration" ("M&A III"), "Mergers & Acquisitions IV: Preliminary Documentation" ("M&A IV"), "Mergers & Acquisitions V: Stock Purchase Transactions" ("M&A V"), "Mergers & Acquisitions VI: Asset Purchase Transactions" ("M&A VI"), "Mergers & Acquisitions VII: Mergers" ("M&A VII") and "Mergers & Acquisitions VIII: Antitrust Merger Control & Clearance" ("M&A VIII") are available at the preceding links, along with other M&A resources on our website at Kurtin PLLC Mergers & Acquisitions and on Lexology.com at the Kurtin PLLC Lexology Hub.

This advisory will focus on how to treat intellectual property ("IP") and rights to IP in U.S. M&A transactions, particularly in the technology and life sciences sectors, in which IP often accounts for a substantial amount of Target's value in the deal. Future editions will focus on issues like financing the M&A transaction; Acquiror's and Target's corporate governance and fiduciary duties in an M&A transaction; Public M&A, in which Target is a public company; Cross-border M&A, in which one of Acquiror and Target is a U.S. company and the other company is domiciled in another country; employment and equity-based compensation, like stock options; due diligence; divestitures, spin-offs, leveraged buyouts and "going private" transactions; M&A involving acquisition of distressed assets or bankruptcy; industry-specific regulatory issues; foreign investment controls; technology export controls; and others.

In this and all future editions of this M&A series, familiarity with the preceding editions linked above will be assumed and previously defined terms will be used without further introduction; however, in this edition, we are introducing an Appendix 1 Glossary of all defined terms introduced to date, and we will update and include it in all future editions. Following the discussion are "Deal Points" on important considerations in the purchase or sale of a business: what to do, and *what at all costs not to do*.

II. IP Types

There are several types of IP that can comprise all or part of a Target's assets:

- Patents are an exclusive and registered right granted by the U.S. Patent and Trademark Office ("USPTO"), an agency of the U.S. federal government, pursuant to the U.S. Constitution, Art. I, s. 8, in an invention, whether a design or a process. A patent holder has the right to prevent others from replicating, marketing or selling the invention or process without the patent holder's permission for a set period: 20 years for "utility" patents (for new and useful process inventions, meaning a method of doing something; and 14-15 years for "design" patents, for new and original designs for products. Patents must be registered by the federal government to be opposable to third parties. Critically, the patent process or design is fully disclosed to the public in the patent filing in exchange for which the government grants its exclusionary protection. The invention or design itself is disclosed; the protection is legal.

- Copyrights are an exclusive right for 70 years plus the life of the author to a creative idea embodied in a tangible work, be it a book, video or audio recording, software code or other; unlike patents, in which the invention, process or design, itself is protected, in copyright, only the embodiment of the creative idea in tangible form is protected. Although copyrights arise automatically and can be asserted by the author by affixing a copyright notice to the work, copyrights can be registered with the U.S. Copyright Office, part of the Library of Congress.

- Trademarks, a name, logo or service mark, indicate a valuable symbol to the public of goodwill and reputation. Like copyrights, and unlike patents, trademarks can arise automatically from use, although they may be more provable and therefore better protected by USPTO registration. Trademark infringement arises when a person or company attempts to use the trademark itself or a similar mark to generate confusion between the trademark holder and other trademark-asserting parties. By contrast, a common defense to a trademark infringement claim may be that there is no danger of confusion between the plaintiff's mark and the defendant's mark, because the two parties are in different industries, use the mark in different contexts, and so on.

- Trade secrets, an industrial or business secret, not registrable with the federal government, which derives its value from not being publicly known, such as a secret chemical formula or

process. Maintaining a process as a trade secret is sometimes a strategic alternative to obtaining a patent for it, particularly because suing for patent infringement is not only expensive, time-consuming and generally uncertain of success, but can even result in an adverse determination by the court that the patent should not have been granted in the first place, giving a victory to defendant, the alleged infringer, and invalidating the patent at the same time. Trade secrets, while not registered by the federal government, can be protected by federal and state law. Unlike patents and copyrights, trade secrets protect against misappropriation but not against independent discovery by a third party or exclusion from use by the third party without misappropriation. If an independent discoverer of the Coca-Cola or Big Mac special sauce formula could establish that it had independently found the formula, there would be nothing Coca-Cola or McDonalds could do about it.

- Data, which can be either digital or analog information accumulated by a Target that has value and can be conveyed in the M&A transaction, supporting part of the transaction valuation and Acquisition Consideration. "Raw" data itself is not an invention or design, and is not patentable, nor in and of itself is the expression of an idea, and is not copyrightable. In some circumstances, manipulated or processed data (the origin of the phrase "data processing") may be considered a trade secret, as when (for example) a customer list easily obtainable or compiled from publicly available sources, and therefore raw data in and of itself, is processed by a Target adding information on specific customer needs and likes, purchasing patterns and other information that transforms the raw data of the customer list into one supplemented with the fruits of work applied to it by Target. In the European Union, the 2018 General Data Protection Regulation, or "GDPR," is an attempt to create controls on personal data of European Union citizens by both "controllers" and "processors" of that data, and must be considered in a Cross-border M&A transaction or even U.S. domestic M&A involving EU citizen personal data.

- Internet IP, which can include domain names, (URLs) and other information registered, given or gleaned from the Internet.

III. Dealing With IP in M&A Transactions

a. Due Diligence.

The identification of Target IP and IP rights is a critical part of Acquiror due diligence. IP, IP registrations and material IP agreements such as licenses and assignments to be included or excluded from the M&A transaction are normally listed in a disclosure schedule or schedules to the Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement, as the case may be. Excluded IP and IP rights may be left with a stub end of Target, or conveyed to a third party, including Target shareholders or management. While it is common to list principally registered IP and IP rights such as patents, copyrights and trademarks in a disclosure schedule, unregistered IP can also be disclosed, often pursuant to confidentiality provisions in a NDA, and viewable by Acquiror or its agents or advisors under controlled conditions, such as a virtual deal room an Internet-based website with access controls.

One of the first tasks and goals of due diligence in an IP-focused M&A transaction is to assess and value Target's IP portfolio. Target may have a large portfolio of dormant and low-value patents, trademarks and other IP that have costs to maintain, but little to no value to the Acquiror. Core IP should be identified and valued; valuation of ancillary IP is less critical. It may have value to the Target post-acquisition, if Target is to continue operations, or it may be abandoned or retired. Either way, the moment of an M&A transaction is a good time to do Spring cleaning of IP portfolios. Also, as described in the previous section, IP, particularly patents, but also copyrights and trademarks, can be challenged not only as to their enforceability in a claim for infringement but as to their validity. Part of the Acquiror's task in conducting due diligence in an M&A transaction is not only assessing the value of the IP itself, but the likelihood of the IP withstanding challenges not only to enforceability, but validity.

b. Assignments and Licenses.

Rights to IP are typically conveyed by assignment, which is usually a general conveyance of the IP with limited, if any, reservations of rights by the assignor; or by license, which is a limited (although sometimes nearly unlimited) conveyance of IP rights, limited by time, scope, exclusivity, permitted uses and other factors, with the overall property right remaining with the licensor. In the case of licenses particularly, it is critical to determine the encumbrances on the Target IP, whether the Target is licensee or licensor. While Acquiror due diligence often focuses on Target as licensee of IP, and limits on its license rights relevant to Acquiror, the effect of license provisions when Target is *licensor* is often

overlooked. If, for example, Target has an IP item listed in its disclosure schedule that supports the Target valuation and Acquisition Consideration, it is crucial for Acquiror to know whether Target has granted an exclusive, royalty-free, unlimited in geographic and other scope and duration, license to a third party that might deprive Acquiror substantially or completely of the use and value of that IP after closing.

c. The M&A Agreement.

In an M&A transaction, generally the key elements of dealing with IP are first, assuring that the Target has the right to convey the IP by assignment or license, usually a matter for due diligence by the Acquiror and then the protection of that assurance in the form of representations, warranties and/or covenants tied to rights of indemnification, termination and conditions to closing in the Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement, as the case may be. Depending on the IP license, it may be critical to obtain consent to the assignment of the license by Target to Acquiror from the third party.

The M&A agreement should also include a representation that no third party is, or is known to be, infringing the IP or IP rights set forth in the disclosure schedule, and that there is no litigation currently pending or known to be threatened respecting any of Target's IP or IP rights. For example, the M&A agreement will generally provide a representation to Acquiror that Target is not infringing any third party IP rights, and an indemnification by Target to hold Acquiror harmless for a stated period of time if Acquiror is sued by a third party (except in Mergers, particularly in Public M&A, in which representations and warranties are often extinguished at closing).

In a Stock Purchase or Merger transaction, the Target's IP is automatically transferred to the Acquiror, unless specifically excluded by the Stock Purchase Agreement or Merger Agreement. In an Asset Purchase Agreement, IP may be specifically included in or excluded from the assets being conveyed; in fact, treatment of IP may figure in the decision of whether the Asset Purchase is structured as one in which all assets are conveyed unless specifically excluded in a schedule, or the reverse, in which only specifically scheduled assets are conveyed, and those not scheduled are deemed excluded (see M&A VI).

IV. Deal Points

Deal Point No. 1: Understand the IP's value in the transaction.

IP's value in a given transaction can vary from negligible to virtually the whole transaction value, and the parties, especially Acquiror, have to understand and value it. Understanding the IP includes not only the original registration or development of the IP, but Target's efforts to maintain it in the time since.

Deal Point No. 2: Make sure that Target has the right to convey the IP in the Transaction.

The right of Target to convey its IP in the M&A transaction, even if originally developed or registered by it, cannot be assumed. Both licenses in which Target is licensee and licenses in which Target is licensor need to be reviewed to ensure that material IP rights have not been encumbered or lost, potentially materially affecting Target's value or even transaction viability.

Deal Point No. 3: Provide deal protections for IP in the event of a transaction not closing.

Unlike stock in a Stock Purchase Transaction or tangible assets in an Asset Purchase transaction, some IP, particularly trade secrets, disclosed in an M&A deal is to some extent out of the bag if the deal does not close. For that reason, it is critical, especially on the Target side, to build protections for IP into the transaction for the case in which the deal does not close. In the case of registered IP, the protection comes with the copyright, trademark or patent registration, for which protective covenants can be made part of the Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement. In the case of unregistered IP, such as a trade secret or a not-patented invention, an NDA that survives termination, tied to the M&A agreement termination provisions, which will provide for Target's retention of its IP, can provide protection, as can indemnifications for any losses arising from Acquiror's disclosure of IP to third parties, liquidated damages provisions, injunctive relief rights and others in the case of a busted deal.

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Mergers & Acquisitions: Deal Points
Cumulative Glossary
Appendix 1

1. **Acquiror (or Acquirer or Purchaser):** the purchaser, or "buy side" party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which acquires all or the majority of the stock or assets of another business. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the dominant party in the transaction, and is often the Surviving Entity (though not always, as in the case of a Reverse Merger or Reverse Triangular Merger), that party can be thought of as the Acquiror.

2. **Acquisition Consideration:** the purchase price paid by Acquiror to Target in an M&A transaction, whether in cash, stock, assumed debt or a combination thereof.

3. **Asset Purchase:** a transaction by which one party to an M&A transaction purchases all or the majority of the assets of another party. Distinguished from a sale by Target in the ordinary course of business, as in selling a part of its inventory, or surplus equipment not needed for continuing its business operations.

4. **Asset Purchase Agreement:** a contractual agreement serving as the principal document by which an Asset purchase is effected.

5. **Cash Election Merger:** an M&A transaction in which Target shareholders are granted an election period to decide whether to accept stock or cash as all or part of the Acquisition Consideration.

6. **DGCL:** Delaware General Corporation Law, serving as a paradigm corporation statute in the U.S., and frequently the basis of incorporation by U.S. companies, wherever physically based, that intend to do business across the U.S. as well as inbound subsidiaries of non-U.S. companies wishing to have operations in the U.S.

7. **Due Diligence:** the scope of the parties' disclosures to each other before the M&A transaction closes, generally buttressed by deal protections in the form of warranties, representations, covenants and linked rights of indemnification, termination, conditions to closing and others.

8. **Exchange Act:** the Securities Exchange Act of 1934, as amended, governing resales of already-issued securities, both debt and equity, and the periodic reporting obligations of publicly registered and listed companies.

9. **Fixed Exchange Ratio:** Where not all the Acquisition Consideration is in cash, parties can also allocate risk of pre-closing volatility through adjustable pricing formulas. In a "fixed exchange" ratio, each of Target's shares is converted into a fixed number of Acquiror's shares based on a negotiated and fixed exchange ratio. Under a fixed exchange structure, the dollar value of the fixed number of Acquiror shares received by Target/Target shareholders can rise or fall in the period after the deal is signed and when it closes, thereby changing the value of the Acquisition Consideration, either as a result of Acquiror's business performance, market reaction to the pending deal, or general market/industry conditions incidentally affecting Acquiror. Fixed exchange ratios are most common in larger, stock-for-stock "merger of equals" transactions, since both parties share the risk of movement in Acquiror's share price. Fixed exchange transactions are also traditionally common in sectors of perceived volatility, such as the tech sector, and Acquiror's resulting position that volatility risk in its stock price should be shared.

10. **Fixed Value Ratio:** In a "fixed value" transaction, it is the exchange ratio that floats and Target shareholders receive a fixed dollar value of Acquisition Consideration, however many Acquiror shares that works out to cost. The formula usually provides for measuring Acquiror's stock price during a negotiated period of days or weeks prior to closing or a meeting of Target's stockholders to approve the transaction. A fixed value pricing formula is used to insulate Target's shareholders from risk from changes in Acquiror's share value prior to closing, whether from the Acquiror's business performance, market reaction to the pending deal, or general market/industry conditions incidentally affecting Acquiror. Fixed value transactions are traditionally most common when one party is clearly Acquiror and the other clearly Target, rather than in the "merger of equals" context and, unlike in fixed exchange ratio transactions, pose the risk for Acquiror that it may have to issue more shares to purchase Target's shares if Acquiror's share value declines during the measuring period, which may reduce the stock value and dilute existing Acquiror shareholders (of course, a rise in Acquiror's stock value prior to closing will allow it to close the transaction on fewer shares). Also, in Public M&A, hostile bidders use fixed value structures because they have more appeal for Target shareholders, who may be solicited under a tender offer and are more likely to tender based on a known dollar compensation for their shares.

11. **GDPR:** European Union 2018 General Data Protection Regulation.

12. **HSR:** Hart-Scott-Rodino Antitrust Improvements Act of 1976 (§7A of the Clayton Act, 15 U.S.C. §18a).

13. **IP:** Intellectual Property, whether Patent, Copyright, Trademark, Trade Secret, Data or other.

14. **JV:** Joint Venture. JVs usually imply a formal collaboration short of merger or acquisition between two or more enterprises through a newly formed business entity or contract, as opposed to Strategic Alliances, which usually involve two or more parties working to achieve a specific goal of mutual interest while remaining independent.

15. **LLC:** a limited liability company organized under a state's LLC statute, generally offering the limited liability protection for shareholders of corporations with the "pass-through" taxation of partnerships (i.e., not taxed at the LLC level, but taxable income or loss is "passed through" to the owners, called "members," equivalent to a corporation's shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.

16. **LP:** a limited partnership under a state's limited partnership statute (usually modeled on the Uniform Limited Partnership Act), generally offering the limited liability protection for shareholders of corporations with the "pass-through" taxation of partnerships (i.e., not taxed at the LP level, but taxable income or loss is "passed through" to the limited partners, equivalent to a corporation's shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.

17. **M&A:** generally used abbreviation for "Mergers & Acquisitions," a catch-all term sweeping up Stock Purchases, Asset Purchases and Mergers, all involving the legal or de facto acquisition of all or a majority of one business's stock or assets by another business.

18. **Merger (or Statutory Merger):** a process set forth in the company law statutes of the individual states by which two companies merge with each other, leaving one company or its subsidiary as the Surviving Entity, while the other company merges into that company or its subsidiary and ceases to exist as a

separate legal entity.

a. **Direct Merger:** A Merger structure in which Target merges directly into Acquiror, which is the Surviving Entity, while Target ceases to exist.

b. **Reverse Merger:** A Merger structure in which Acquiror merges into Target, which is the Surviving Entity, while Acquiror ceases to exist.

c. **Forward Triangular Merger:** A Merger structure in which Acquiror forms a subsidiary (**Merger Sub**) (or uses a pre-existing subsidiary), Target merges into Merger Sub, Merger Sub is the Surviving Entity and a subsidiary of Acquiror, while Target ceases to exist.

d. **Reverse Triangular Merger:** A Merger structure in which Merger Sub merges into Target, Target is the Surviving Entity and becomes a subsidiary of Acquiror, while Merger Sub ceases to exist.

All of these Merger structures are diagrammed in M&A I.

19. **Merger Agreement (or Agreement and Plan of Merger):** a contractual agreement serving as the principal document by which a Merger is effected.

20. **Preliminary Document: (MOU, or Memorandum of Understanding; LOI, or Letter of Intent; or Term Sheet. Also, NDA, or Non-Disclosure Agreement, which may be part of an MOU, LOI or Term Sheet or a standalone Preliminary Document):** forms of preliminary documentation used to set a framework for an M&A transaction and confidentiality before executing documents like an Asset Purchase Agreement or Stock Purchase Agreement. Some terms in preliminary documentation may be binding on the parties for a certain period, for example confidentiality or exclusivity, while others are usually not binding.

21. **Public M&A:** M&A transactions involving a Target that is a public reporting company under the Exchange Act, requiring a substantial Exchange Act and SEC regulatory overlay of requirements for the transaction. While in nearly all such cases, the Acquiror will also be a public reporting company, that is not necessarily the case. Nearly all Public M&A is conducted by Merger.

22. **SEC:** the Securities and Exchange Commission, the U.S. federal securities regulator.

23. **Securities Act:** the Securities Act of 1933, as amended, governing initial issuances of securities, both debt and equity.

24. **Stock Purchase:** a transaction by which one party purchases all or the majority of the stock of another party. Distinguished from a minority investment by one party in the other, such as a typical venture capital investment, which is not an M&A transaction.

25. **Stock Purchase Agreement:** a contractual agreement serving as the principal document by which a Stock Purchase is effected.

26. **Surviving Entity:** the company that continues its corporate existence and operations following a merger.

27. **Target (or Seller):** the seller, or "sell side" party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which sells all or the majority of its stock or assets to another business, the Acquiror. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the less dominant party in the transaction, and is often the merged party (though not always, as in the case of a Reverse Merger or Reverse Triangular Merger, that party can be thought of as the Target.

28. **Tax Code:** the U.S. Internal Revenue Code, 26 U.S.C.

29. **TCJA:** the Tax Cut and Jobs Act of 2017.

30. **USPTO:** U.S. Patent and Trademark Office.