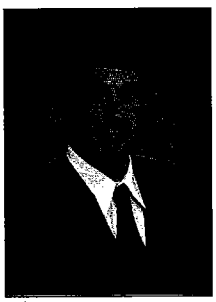
IAN MCCLURE

Due Diligence for Intellectual Property: Shifting the Practice from Ex Post Facto to Ex Ante Facto

The 1990s was the decade of information technology; the 2000s was the decade of intellectual property, or IP; and the 2010s will be the decade of intangible assets. With this development, comes the responsibility for every company in the new decade to identify, organize, and efficiently manage its corporate assets that consist of intellectual property rights. The list of such assets includes not only the traditional patented technologies, copyrighted content, and trademarked brands but also any justifiably confidential information, such as internal processes, customer lists, and data compilations. Although these assets have increasingly constituted the major portion of corporate value for many companies over the last two decades, the identification, organization, and management of these assets has largely been an ex post facto practice that is conducted in anticipation of arising litigation or a merger or acquisition (M&A). The growing amount of corporate value attributable to intangible assets has forced the need for this ex post facto procedure to become an ex ante facto routine. This change is evidenced by the growing number of chief intellectual property officers on the staff of large or IP-rich corporations and by the morphing services offered by lawyers in private practice who specialize in IP to mirror an outside-counsel version of company's chief intellectual property officer. If the business advantages of identifying and managing IP *before* a legal event aren't enough to entice a company to take on this responsibility, federal corporate disclosure laws and director liability rules may require such practices for compliance purposes going forward.



IP Due Diligence: Ex Post Facto

IP due diligence is the process of conducting an internal IP audit to help recognize a company's intangible assets and any risks involved. For the most part, when a merger or acquisition is in progress, IP due diligence has been conducted only ex post facto after the execution of closing schedules or a letter of intent to purchase corporate assets. Of course, IP due diligence arising out of M&A is necessary. According to a recent study conducted by the Mergermarket Group,[1] 85 percent of corporate respondents reported that a target company's IP assets had importance equal to or greater than other corporate assets. Nevertheless, the crunched time frame in which IP due diligence must be conducted for an M&A is not sufficient to perform adequate diligence. In the same study, most corporate respondents identified inadequate due diligence as the reason for failing to identify IP risks; 56 percent identified a lack of time as the reason, while 46 percent identified a lack of immediate resources.

Numerous case studies provide evidence of the shortfalls of IP due diligence in the M&A context. The most of famous of these is the purchase of Rolls-Royce's assets by the Volkswagen AG Corporation in 1998. To the embarrassment of Volkswagen, it was discovered only after the deal had been closed that Volkswagen had failed to purchase the famous Rolls-Royce trademark free and clear of any other interests in the mark. These other interests, which should have been discovered by IP due diligence efforts, led to the eventual transfer of the trademark to BMW. According to Ferdinand Piech, then chairman of Volkswagen, if adequate IP due diligence had been performed, "the price would have been much lower than Volkswagen finally paid."[2]

Such due diligence deficiencies are not only a tale of the past. One case, *Cincom Systems Inc. v. Novelis Corp.*,[3] which was heard by the Sixth Circuit in 2009, serves as another example of the results of failure to properly identify and evaluate IP risks in the M&A context, setting a precedent requiring IP due diligence even in the case of a corporation's internal restructuring. In this case, an entity that eventually became known as Novelis Corp. after an internal merger was the licensee of software owned by Cincom Systems. The license granted the licensee "a non-exclusive and non-transferable license" and stated that the licensee may "not transfer its rights or obligations under [the agreement] without the prior written approval of Cincom." After learning of the internal merger between the licensee and a subsidiary, Cincom Systems brought suit for breach of the license and for copyright infringement. The Sixth Circuit found that Ohio's merger statutes provided that the license once held by the original licensee automatically vested by operation of law in the survivor of the internal merger, Novelis. Furthermore, such a vesting by operation of law is, in effect, a transfer. Therefore, the court held that an improper transfer of the license occurred as a result of the internal merger, and Novelis breached the license and also infringed Cincom's copyright.

Adequate IP due diligence would have discovered the nontransfer provision in the license agreement and should have raised a red flag despite the fact that this was a case of first impression in the Sixth Circuit with respect to the internal restructuring. The facts of this

case highlight the inefficiencies in conducting IP due diligence only as an ex post facto reflex to M&A events. In this case, the internal restructuring should have been quick and painless. The cost and time associated with adequate IP due diligence make it appear that the process is not worth the effort in most internal restructuring cases, yet now we know that it is required—otherwise, more expensive consequences may result. The answer is not to conduct ex post facto IP due diligence in anticipation of each internal restructuring event but, instead, to conduct ongoing ex ante facto IP due diligence so that only a quick examination of organized diligence charts will answer all necessary questions at the time of each event. This practice will also provide many more benefits outside the context of a merger and acquisition.

IP Due Diligence: Ex Ante Facto

The Advantage for Businesses

In an M&A event, due diligence is the practice of fact-checking the representations and warranties set forth in the documents related to the acquisition. The process is also a diligent investigation of the acquisition target to make sure that no hidden sleeping liabilities are left under the covers. But due diligence is not inextricably tied to the M&A process. In fact, IP due diligence should be a routine procedure in which every company engages for its own well-being, examining its own sleeping liabilities and undiscovered assets. Ex ante facto due diligence is essentially an organizational process—a method for keeping track of every component of a business entity. Due diligence is a practice that every organization hoping to become an acquisition target should undertake. In conducting routine due diligence, such an organization can keep from appearing like an amoeba and instead resemble a well-formed entity.

The benefit of conducting ongoing ex ante facto due diligence is greater when it comes to intellectual property, which carries with it the burden of being frequently misunderstood and is presumed to represent high risk. For this reason, it is helpful for any hopeful acquisition target to be able to identify and present to a potential buyer the IP at hand and its up-to-date maintenance record precisely. Private equity firms and other purchasers want this information to be readily available and well organized. Having this information often means the difference between closing a deal or remaining on the market.

Ex ante facto IP due diligence may also solve many problems intrinsic in the IP management process. An IP portfolio that contains numerous trademarks and patents will require frequent renewals and other upkeep duties. If licenses are involved, numerous royalty accountings or audits may need to be performed. An organized and ongoing IP due diligence routine will make the management of this portfolio much easier. Finally, ex ante facto IP due diligence may help a company discover confidential or proprietary information that needs protection in order to secure its value to the company. In short, IP due diligence is the very process that helps a company—and others—understand its intangible assets.

Use for Compliance Requirements

Ongoing ex ante facto IP due diligence not only is a practice that can benefit a business but also is now considered a practice needed to comply with government regulations. The federal Sarbanes-Oxley Act of 2002 (SOX) and other legislation dealing with corporate disclosure requirements have resulted in significant implications on corporate practices dealing with intellectual property. SOX was enacted to require greater corporate and auditing accountability and responsibility with regard to accurate disclosure and reporting of company assets and value. Because intellectual property holds great value for many companies, and this value is directly tied to balance sheet numbers and therefore shareholder value, intellectual property is a financial asset that must be disclosed and reported under the provisions of the act. Section 302 of SOX requires that senior executives be personally responsible for corporate financial reports and other internal processes that control accounting disclosures. Any deficiencies or misrepresentations in these reports can be attributed directly to the corporation's executives. Therefore, it is important for corporate management to stay informed about their companies' assets, including intangible assets. The fact that valuing intellectual property has never been standardized lends even more significance to the role of routine IP due diligence. Leaving an organized paper trail resulting from routine IP due diligence will help ensure regulators that corporate management has taken the proper steps to account for a company's intangible assets accurately.

In addition, § 404 of SOX requires corporations to establish and maintain internal processes for identifying and reporting financial assets, including producing routine publications concerning the efficiency of these processes. Well-documented IP due diligence practices can bode well for a company in its attempt to show that it is in compliance with § 404 of the act.

With regard to corporations to which SOX does not apply, liability rules related to directors are significant because the rules require directors to be accountable for oversight of internal processes that recognize and manage important intangible assets. Directors' liability for mismanaging intellectual property generally falls under two categories: waste and incorrect valuation, both of which stem from a lack of understanding or attention paid to the relevant IP assets. Intellectual property is frequently an asset whose value diminishes over time—for example, patents expire, technology is superseded and becomes obsolete, and so forth. Thus, directors could become liable if the company fails to obtain complete information and does not make sound business judgments that account for this inherent quality. Similarly, if IP is not secured, utilized, or managed correctly during its window of opportunity, it could subject a director to liability if a reasonable business person would have

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makes it possible to design presentations online.

Not only is Prezi a radical departure from the ubiquitous and often yawn-producing traditional presentation software produced by Microsoft, but Prezi also literally changes how you create presentations. Prezi is more—no pun intended—"out of the box" than in the box. You don't create individual slides, you create nonlinear presentations and then you zoom in and out of a sort of map that contains all your information. (For that reason, some critics have said that a Prezi presentation can be dizzying, but it can also be transformative and exhilarating.) When it comes to results, Prezi is actually fairly similar to pptPlex™, which is produced by Microsoft Labs (which offers a somewhat similar type of functionality within PowerPoint), but pptPlex is software embedded within PowerPoint. (Go to www.officelabs.com/projects/pptPlex/Pages/default.aspx.)

It's difficult to explain how to use either software in conceptualizing a presentation, but neither is particularly difficult to use. The best way to learn how to use either of these products is to view the example presentations that are on the products' Web sites and then just dig in. Both sites have helpful example videos that will help you create your own nonlinear presentations the first time you try.

Prezi and pptPlex presentations are less plodding and methodical, so the more thoughtful behind-the-scenes planning for each presentation definitely takes some getting used to, but after a bit of practice you will find that the user interfaces are quite intuitive and you'll soon get the hang of how to go about it. Your resulting presentations are guaranteed to be distinctly different from those of your peers. (Prezi comes in two basic flavors. One is free and the other, with more features and more adaptability and storage capability, can be purchased for a fee; pptPlex is a free download.)

Conclusion

There are many interesting solutions to common problems available in Cyberia, if you know where to look. I hope I have pointed you to a few that will solve problems you have encountered. See you next month in Cyberia. **TFL**

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taken some action with respect to that intangible asset.

The Delaware case of *In re Caremark Int'l Inc. Derivative Litig.*[4] created the duty of oversight for directors, opening up directors to greater risk of liability for not overseeing the internal systems the company uses for managing assets. In this case, the court noted that an ongoing employee training program that teaches them about those assets is one way to relieve a director of liability. Similarly, ongoing ex ante facto IP due diligence is one way that directors can ensure that they remain completely informed with regard to a company's IP assets and the risks involved. Obtaining complete information before making any significant business judgments is the only way directors can shield themselves from liability. Therefore, because IP assets are so easily misunderstood, conducting IP due diligence ex ante facto should be an exercise for every corporation.

Preparing for the Decade of the Intangible Assets

As the category of intangible assets, including intellectual property, sheds its skin as a cost center requiring ex post facto treatment, this portion of corporate value gains momentum as a formidable asset class joining other such assets on balance sheets and in the decision-making processes that take place in corporate boardrooms. As a result, heightened investment and regulatory expectations accompany this label. Private practitioners who specialize in IP law are beginning to anticipate the shift by offering strategic IP management services; some have even changed their appellation to "IP strategist." In addition, as the position of chief intellectual property officer within a corporation gains visibility and importance, law schools are beginning to offer IP management classes and programs (such as the new master's degree program in IP Management and Markets at Chicago-Kent College of Law). Therefore, as the legal profession prepares for the reallocation of client needs, the real onus to help company management understand the importance of ongoing ex ante facto IP due diligence in the new decade has been placed on lawyers. **TFL**

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Endnotes

[1]Mergermarket Group, M&A Insights: Spotlight on Intellectual Property Rights, 2008, *available at* www.mergemarket.com/pdf/Intellectual_Property.pdf.

[2]*BMW Wrests Rolls-Royce Name Away from VW*, N.Y. TIMES (Jul 29, 1998), *available at* www.nytimes.com/1998/07/29/news/29iht-rolls.t.html?pagewanted=2.

[3]*Cincom Systems Inc. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 2009).

[4]*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (approved by *Stone v. Ritter* in 2006).