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Shay & Partners

The IPR Audit

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Introduction

Smart companies don't simply take at face value the word of their counterparts regarding the worth or integrity of their assets—where justified, such representations are confirmed through a comprehensive due diligence investigation. An audit of the target's assets should be performed prior to any merger or acquisition, or substantial investment in a new or existing venture; a company should also perform an internal review prior to an initial public offering (IPO). This is especially true with respect to local companies in the Greater China Region, as transparency and corporate governance standards in this area are generally lower than they are in nations such as the U.S. and U.K., and avoiding telling “hard truths” is routine here.

Failure to perform such a preliminary due diligence investigation can have disastrous consequences. If, for example, you have acquired a company whose patents infringe those of a competitor, you may find yourself not only excluded from the relevant market, but also forced to pay a competitor an extremely high damage award. In this respect, it should be borne in mind that post-merger a company in most jurisdictions is deemed to have assumed the liabilities of the acquired company.

Judging the value and integrity of a company's intellectual property rights (IPR) can be especially challenging for a host of reasons, many of which relate to their intangible nature. The IPR audit requires for its successful execution the services of a multidisciplinary team composed of experienced accountants and attorneys, management representatives and, where appropriate, experts in the particular technologies at issue. The following short guide provides only a basic overview of some of the legal aspects of the IPR audit, and should not be regarded as a substitute for obtaining the advice of legal or other professional counsel.

The Basic Procedure

1. Decide Strategy and Scope

The goal of the IPR audit is to provide the investigating party sufficient information so that it can make a reasonable decision about whether or not to conclude the contemplated transaction with the target counterparty. The results of the investigation should determine or confirm the appropriate contractual terms that will govern the transaction, including price. The first key step therefore is ensuring all members of the due diligence team fully comprehend the purpose of the transaction.

If, for example, the objective in a proposed merger is to acquire the target company's patents for a particular product, the team can focus from the start on particular questions relevant to that objective. Identifying the objective helps to clarify the necessary scope of the review. It may not be necessary to spend equal time and effort reviewing the target company's entire IPR portfolio; if some of it is deemed not useful, there may be an opportunity to unload extraneous IPR to help fund the deal.

2. Acquire the Information You Need

Upon deciding your objective and the scope of the review, the next step will be for the team to write up a comprehensive questionnaire to be answered by the target with appropriate warranties given ensuring the accuracy and comprehensiveness of its responses. Prior to or at the same time the questionnaire is being prepared, a comprehensive search of available public and other third party information regarding the target and its assets should be reviewed.

Despite the execution of non-disclosure agreements by the due diligence team, the target may be reluctant to provide some of the requested information. This is especially true of East Asian companies, which may be unaccustomed to providing “outsiders” a high degree of transparency into their corporate activities. A potential compromise that may be offered to the target is review of all the target’s documents in a “safe room” controlled and monitored by the target. If the target refuses to provide such information because doing so would be “insulting” or is otherwise unduly resistant to the process, it may be best to walk away from the deal rather than conclude the transaction blindfolded.

Information to be sought via the questionnaire is likely to include the following:

2a. Inventory of Products and Services

Obtaining a full inventory of the target’s products and services will help identify at an early stage of the review potential risks and hidden values. The target company may itself not fully understand the IPR at issue, and a listing of products and services will therefore assist in the task of identifying and categorizing the subject IPR. For example, if the target’s product inventory includes software, you will want to review whether it is self-owned or licensed, whether there are patents registered by the target protecting rights in such software (in jurisdictions where such protection for software is available), whether there are patent / copyright infringement issues, etc.

2b. Inventory of the Company’s IPR

The target should list all of its IPR, and the basis for claiming each such asset (e.g., self-owned or licensed). Principal forms of IPR the target will list may include patents, trademarks and trade secrets.

2c. Full List of IPR Registrations and Pending Applications

The target should provide a full list of patent and trademark registrations, and, in those jurisdictions which allow it, copyright registrations. Such listing should be accompanied by official documents from the granting authorities evidencing the registration. The target should state the grant and expiry date for each such registration, and the scope of the right registered. For example, for patents the target should include not just the patent number issued, but also the document showing the claims granted for that patent; for a trademark, the product (and service) classes in which the mark has been registered. Where applicable, proof of renewals, payment of fees, and use of the IPR in commerce should be provided (in many jurisdictions, failure to use a trademark may result in it being deemed abandoned by the owner).

2d. All Contractual Documentation Relating to the IPR

Copies of all contracts the target has executed pertaining to the subject IPR should be obtained. Inter alia, this should include any IPR licenses and assignments, as well as development and distribution / supply agreements (not to mention joint venture agreements, etc.). It is in fact advisable to request a copy of every contract the company has executed to help avoid the risk that the target will fail to provide contracts (intentionally or unintentionally) in which important terms relating to the subject IPR may be buried amongst a host of unrelated terms.

This should include any settlements or other agreements relating to the IPR of other companies, even though the target is not currently using such assets.

2e. List of Past, Current and Contemplated Litigation

This list should include both litigation commenced by and against the target, and any in which it has been required to provide third party testimony. It should include a list of all litigation that has not yet been filed but which the target is considering filing.

In addition, the target should include any demand letters or other communications from or to third parties warning of litigation or otherwise advising of potential litigation issues.

2f. List of any Known or Suspected IPR Infringement

The target should describe any acts of potential infringement by or against the company. This may include knowledge of counterfeiting of the company's products / mark, or knowledge by the company that its products infringe the patent of a competitor, even though the competitor itself has not yet become aware of this fact.

2g. Company Policies to Prevent IPR Infringement and Protect Trade Secrets / Confidential Information

The target should describe the policies it follows to check for infringement by it of the IPR of third parties, and warrant that it has consistently enforced such policy at all levels within the company. It should also describe what measures it employs to check for infringement by third parties of its own IPR (and again, proper warranties should be given). The company should also describe how it protects any trade secrets it claims, and how it generally protects its confidential information. Evidence should be provided of the existence of such policies (e.g., printed manuals) at all relevant times.

2h. Employment Contracts

Copies of the employment contracts of all past and current employees should be obtained; in the event the target is large and this would be cumbersome, review of the contracts of past and present key employees (e.g., IPR developers and high-level management) should be given priority.

Where appropriate, any prior employment contracts of company founders and other key employees with third party companies should also be obtained.

2i. Interviews with Key Employees, Directors and Other Principals

Interviews are one good means to check the accuracy of paper documents. All key employees and all directors of the target should be interviewed, as well as other principals that can be identified (it is frequently the case in East Asia that true control of companies rests in the hands of a person(s) who is not an employee, director, or even direct shareholder).

Where appropriate, the answers should be given by way of sworn affidavit. It may also be advisable to obtain interviews with past employees, directors, etc. if this is possible. Interviews should also be obtained with the principals of any key clients and business partners of the company.

3. Analyze the Acquired Information and Determine Value of the Subject IPR

Upon obtaining all of the information requested in the initial questionnaire, analysis of it should follow. Key steps in analysis of this information should include the following:

3a. Validity and Control of the IPR

This is obviously a step of paramount importance. Ensure that the company owns outright its IPR without any encumbrances, or if the IPR has been licensed to it, that the license is transferable to you. Issues to consider in this context are the following:

- Have currently valid registrations of the IPR been obtained in all relevant jurisdictions? If applications are pending, what is their status and likelihood of registration?

This should be ensured not simply by checking the documentation provided by the company, but by a manual search with the issuing authority (or at least checking its database).

Failure to obtain a patent on patentable subject matter within the statutory time limit, or failure to be the first to file for protection of a patent or trademark, may result in an ownership bar.

Where an application of the target is pending, it is important to check the application history, including whether any conflicting and pending applications have been filed by third parties, any filing of current and pending oppositions, etc.

-Is it the opinion of legal counsel that the claimed IPR meets the prerequisites for protection and, where applicable, doesn't infringe on other registered IPR?

Generally, registration of IPR isn't dispositive as to the validity of the IPR. Courts around the world frequently invalidate patents and trademarks that have been issued by the relevant government authority. It may be that the IPR should never have been issued because it didn't meet legal requirements for such, or, more frequently, that the IPR infringes on other registered IPR.

As regards any claimed trade secrets, most jurisdictions have requirements that must be met before a given process, etc. will be subject to protection as a trade secret. The security measures employed by the company, and the extent to which the subject information is known / used by third parties, will have to be scrutinized.

-Can any other party claim ownership or any other interest in the IPR?

The line of title to the IPR should be traced back to its creator / inventor. If the company claims ownership of the IPR, can it prove who within its company invented the IPR, and that the company presently owns it free of the claims of the inventors? Examination of the employment contracts of the inventors will be necessary in this regard to ensure that they have assigned to the company any of their developments. The importance of this will vary from jurisdiction to jurisdiction and also as regards the IPR in question, but will be especially important as regards any IPR developed by independent contractors. Care should also be taken to examine any former employment contract of the company founder, if the founder claims to be the inventor of the IPR (in the event the founder invented it while in the employ of another company, there may be ownership issues).

Where the IPR was invented jointly by the target and one or more other companies, the development agreement will have to be carefully scrutinized.

Review of any purported licenses executed with third parties should be made to ensure that the IPR has not actually been assigned away due to poor wording (this is unfortunately not as rare as one would think in some jurisdictions in East Asia).

Note the chain of title should also be checked, where possible, with regard to IPR licensed to the target by a third party.

In the event joint ownership of IPR or other ownership problems are discovered, it may be possible to remedy this before the transaction is completed.

- Are there any third party licenses that will impact your free use of the IPR?

If the target's rights to the IPR do not stem from its ownership of it and are instead licensed to it, check the governing license agreement to ensure the target may freely transfer (or sublicense, depending on the contemplated transaction) the IPR to you. If not, make sure written approval from the licensor has been obtained in advance of the transaction. In the event the licensor is itself a sublicensee of yet another third party, trace the line of licenses back to the original master license agreement.

Check the scope of the license grant with respect to any time, geographical or other restrictions on use of the IPR. In particular, check carefully the scope of the grant clause. As regards some IPR such as copyright in which the bundle of rights in the IPR may be held by multiple parties, if the licensor has only granted some rights (e.g., display) but not others (e.g., reproduction), the license may be so limited in scope as not to be useful.

Special care should also be used to check for license by the target of its IPR to third parties. Recordation and registration of such licenses should be checked with the granting authority, in addition to any documentation the target may provide in this regard. Even if the target owns the IPR outright, if it has granted a currently effective exclusive license to a third party, this may preclude you from exploiting the IPR during the term of such license.

- Are there any security interests encumbering the IPR?

The target's and, where possible, government records should be checked to ensure that the target has not granted a third party a lien or other encumbrance on its IPR specifically, or all of its assets generally.

- Are there any government approvals that are a prerequisite to exploitation of the IPR?

If the proposed transaction is a merger, and the merger is subject to government approval, this will obviously be an issue. If any approvals are necessary from the government in order to exploit the IPR post-merger, you should check to ensure that such have been obtained by the target and are freely transferable to you. An example of this are the strict controls under U.S. law and the laws of some other nations on the export of "dual use" technologies, including many integral to the business of hi-tech companies; merger and subsequent transfer of the IPR to a foreign or foreign-controlled company is likely to trigger these laws and specific approvals will have to be obtained. This will also be an area of special concern in highly-regulated regimes such as the PRC, especially where the acquiring company is foreign or foreign-controlled.

- Are any antitrust issues likely to arise if I exploit the target's IPR?

This is mainly a concern as regards patents that will be acquired from the target, especially where the resulting patent pool will allow monopoly dominance of an industry. Care should be used to check for any actions, warning or inquiries from the government authorities in this regard, both with respect to the target and acquiring companies.

3b. Strategic Value of the IPR

This will be a question both for the attorneys and the acquiring company's industry / market expert. From the legal side, the attorney should consider the following:

- For patents, how broad are the claims that have been granted, and how easily can a competitor design around them?

- For trademarks, how strong is the registered mark, and does it provide coverage in all of the desired classes?

- Will the target's patent or other IPR enable the acquiring company to bring strategic litigation against a rival and potentially knock them out of a particular market?

3c. Liability Risks Associated with the IPR

This will need to be considered in every relevant jurisdiction. Areas for inquiry here are as follows:

-What litigation is current or pending against the target regarding its IPR, and what is the likelihood of success of such litigation?

- What is the likelihood that claims will be brought against the acquiring company in the future regarding the acquired IPR?

3d. Valuation

This is the domain of the accountant and professional actuary / appraiser. The legal issues identified through the above IPR audit will be factored into a proper monetary valuation of the target and its IPR assets.

Conclusion

A successful and comprehensive IPR audit will permit the party making such inquiry to identify hidden risks and values, and decide an appropriate transaction value and governing contractual terms, or in the alternative determine that the transaction is not worth pursuing. Skipping this vital step, or performing it improperly, is an invitation to disaster and a company does so at its own peril; depending on the jurisdiction of incorporation, its directors may even bear liability for negligent failure to perform such review. All in all, the professional fees of a properly-managed due diligence team will be paid back in spades by the information provided through the audit and the security that information provides; risk in and of itself is a real transaction cost that a company cannot afford to ignore.

Disclaimer: The guide above is cursory and only representative of some of the steps that should be taken in a proper due diligence exercise. It is provided for general informational purposes only, and should not be relied upon as legal advice.