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Top Intellectual Property Issues to Think About in M&A Deals

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An overview of intellectual property considerations in M&A transactions, which can impact valuation and the ability to operate after closing. In today's M&A transactions, intellectual property ("IP") represents an increasingly critical component of a target company's value. Therefore, during the due diligence process it is important to understand what IP a potential target actually owns, what third-party IP it relies on, whether the target may be infringing a third party's IP, as well as how the proposed transaction could impact the buyer's rights in the target's IP. Below, we highlight several IP considerations and red flags in U.S.-based M&A transactions. For transactions involving non-U.S. target companies or businesses, local law considerations may need to be assessed.

1. **Scope of IP; Impact of Transaction Structure**

Understanding the scope of IP that will be included in a particular transaction, and confirming whether the target company or seller actually owns the IP that it purports to own or sell, should be a primary concern for a potential buyer. A buyer should conduct global database searches to confirm the registered IP held by a target company or seller, as well as to identify any chain of title issues, recorded liens, and any legal or regulatory proceedings that may have been initiated with respect to such IP. In an equity purchase transaction, the buyer will typically acquire all of the target's (or its parent's) equity interests, and therefore inherit all of the target's IP holdings automatically by virtue of the transaction. Conversely, in a transaction structured as a purchase of assets, a buyer will only acquire the IP that is expressly transferred under the purchase agreement. As such, it is critical to understand what IP is included and what IP (if any) will remain with the seller, and confirm that the transferred IP is sufficient to operate the target's business. It is also important to review any outbound licenses to determine whether the target has granted to a third party any exclusivity or ownership rights in the target's IP, and understand whether any of the target company's contracts contain a "springing license" that could grant to a third party IP rights by virtue of the consummation of the proposed transaction, as this could impact the valuation of the target company. In addition to understanding what IP a target owns, it is important for a buyer to understand what third-party licenses are required to operate the target's business. A buyer should review those licenses to identify any restrictions on the buyer's ability to receive the benefit of those licenses post-closing. While license agreements will often flow through automatically in a transaction structured as an equity purchase, in an asset purchase scenario each license agreement must be expressly assigned by the seller to the buyer, which in many cases may require the consent of a third party. Moreover, even in an equity purchase scenario, it is important to diligence and understand any change in control restrictions, including anti-assignment provisions, that may be triggered by the proposed structure. Unlike typical contracts, IP licenses are considered to be personal to the licensee and by default are not transferable without the consent of the licensor. Proper review of a business's material license agreements is critical to avoid last minute surprises or situations in which a third party can create unanticipated hurdles to a smooth deal closing. If consent cannot be obtained, it is important to understand the effect losing the IP rights (or license fees or royalties) will have on the target's business, as this may impact the deal's valuation.

2. **Comingling of Intellectual Property**

Related People

Daniel Angel

Meghan M. Hungate

Robert B. Little

Saee Muzumdar

Sarah Scharf

In some instances, a seller may have comingled certain IP among the business it proposes to sell and the businesses it plans to retain. In such instances, both the buyer and the seller may need continued access to that IP following the closing of the transaction. Comingling of IP in this manner may require the buyer and seller to negotiate an ongoing license agreement between them, which will typically establish clearly defined purposes for which each party may (and may not) use the IP going forward. In some cases, the parties may negotiate time-limited restrictive covenants in addition to such ongoing license agreements. Restrictive covenants should always be reviewed by an antitrust expert to confirm they are drafted in an enforceable manner.

3. **Treatment of IP in Employee and Consultant Agreements**

It is important to evaluate the target's forms of employee and independent contractor invention assignment agreements to confirm that such individuals have properly assigned to the target all applicable IP rights – or, if not, to identify critical gaps that must be remediated before the transaction can close. Best practice is that such agreements should contain presently effective assignment language that makes the IP assignment from the employee or contractor to the target company effective immediately, rather than requiring any future execution of documents. Companies hoping to be acquired in the near future may wish to review these forms and improve them before any deficiencies turn into a deal hurdle. Founders in particular should ensure that their companies are the proper owners of any founder-created IP, as buyers and even potential investors will be on the lookout for any possibility that a founder could replicate the business under a new company. If any IP development work is performed outside of the United States, it is advisable to consult with local counsel in the relevant jurisdiction to ensure that the invention assignment provisions are enforceable under local law.

4. **AI Generated Content**

As companies are increasingly relying on artificial intelligence ("AI"), a buyer should review whether and how the target company uses AI in its business. Recently, the U.S. Copyright Office clarified its practices for examining and registering works containing material generated by AI. However, the use and ownership of AI is an area of the law that is currently under development as the legal system attempts to catch up with this new technology. If a target relies on AI tools to generate content considered material to the business value, careful analysis should be undertaken to determine whether the AI outputs are actually copyrightable, or whether they will be deemed outside the scope of copyright protection. Further, it is important to understand the inputs a target company uses to train its AI, as certain uses of third-party copyrighted materials can lead to claims of infringement or misappropriation.

5. **Joint Ownership**

Joint ownership of IP creates complications that many buyers and sellers may wish to avoid. For example, each joint owner of a patented invention can independently sell, license or otherwise exploit the patent without any duty to account to or seek consent from any other joint owner (including the right to license the patent to a third party that is in an infringement dispute with the other party over such patent). A buyer should therefore pay special attention to agreements that cover joint ventures or joint development of IP or technology, and growth-stage companies looking to make themselves attractive to future buyers should carefully weigh the benefits and potential risks of joint ownership before entering into any such arrangements.

6. **Upward-Reaching Affiliate Issue**

A buyer (especially if it has a valuable patent monetization program) should conduct a careful review of a target company's license agreements – particularly any with the buyer's direct competitors – to identify provisions that may become binding on the buyer of the target company upon closing. In many agreements, the term "affiliate" is defined broadly to include any entity that controls, is controlled by or is under common control with the licensor, such that, upon closing, the license granted by the target could be deemed to encompass the buyer's entire IP portfolio as well.

7. **Adequate Protection of Trade Secrets (Including Source Code)**

For many companies, trade secrets are their most valuable IP asset. Therefore, it is important for a buyer to confirm that such trade secrets are adequately protected, including the source code to the target's proprietary software. A buyer should confirm that all employees and contractors, as well as other third parties with access to the target company's trade secrets, have executed non-disclosure agreements, and should review such agreements to ensure that they reasonably protect the target company's trade secrets and other confidential information and prohibit recipients thereof from disclosing such information. It is also important for a buyer to confirm that the target company has industry-standard controls in place, including appropriate organizational, administrative, technical and physical measures, to ensure the confidentiality and security of the IT systems that house its trade secrets and other confidential information. If proprietary software is the target's most valuable IP asset, the buyer should also confirm that the source code to the software has not been disclosed to (and is not required to be disclosed to) any third parties and review any source code escrow agreements to confirm that the proposed transaction would not trigger a release.

8. **IP-related Disputes**

Finally, a buyer should review any IP-related lawsuits, settlements, and coexistence arrangements, as well as any claims of IP infringement, including in the form of offers or invitations to obtain a license or requests for indemnification, and ascertain the status and materiality of, as well as the likely cost associated with resolving, any pending disputes. Settlement agreements may include a covenant not to sue, whereby the target company agrees not to assert its IP rights against the counterparty for particular uses or products. A buyer should consider how this would impact its rights in the acquired IP, as well as whether an overly broad definition of "affiliate" could cause the buyer to be similarly bound not to enforce its IP against the other party, either of which could affect the target company's valuation depending on the buyer's go-forward plans.

The following Gibson Dunn lawyers prepared this update: Daniel Angel, Meghan Hungate, Robert Little, Saee Muzumdar, and Sarah Scharf.

Gibson Dunn lawyers are available to assist in addressing any questions you may have about these developments. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Mergers & Acquisitions, Private Equity, or Technology Transactions practice groups, or the following authors and practice leaders: **Technology Transactions**: Daniel Angel – New York (+1 212.351.2329, dangel@gibsondunn.com) Carrie M. LeRoy – Palo Alto (+1 650.849.5337, cleroy@gibsondunn.com) Meghan Hungate – New York (+1 212.351.3842, mhungate@gibsondunn.com) **Mergers and Acquisitions**: Robert B. Little – Dallas (+1 214.698.3260, rlittle@gibsondunn.com) Saee Muzumdar – New York (+1 212.351.3966, smuzumdar@gibsondunn.com) **Private Equity**: Richard J. Birns – New York (+1 212.351.4032, rbirns@gibsondunn.com) Wim De Vlieger – London (+44 20 7071 4279, wdevlieger@gibsondunn.com) Federico Fruhbeck – London (+44 20 7071 4230, ffruhbeck@gibsondunn.com) Scott Jalowayski – Hong Kong (+852 2214 3727, sjalowayski@gibsondunn.com) Ari Lanin – Los Angeles (+1 310.552.8581, alanin@gibsondunn.com) Michael Piazza – Houston (+1 346.718.6670, mpiazza@gibsondunn.com) John M. Pollack – New York (+1 212.351.3903, jpollack@gibsondunn.com) © 2024 Gibson, Dunn & Crutcher LLP. All rights reserved. For contact and other information, please visit us at www.gibsondunn.com. Attorney Advertising: These materials were prepared for general informational purposes only based on information available at the time of publication and are not intended as, do not constitute, and should not be relied upon as, legal advice or a legal opinion on any specific facts or circumstances. Gibson Dunn (and its affiliates, attorneys, and employees) shall not have any liability in connection with any use of these materials. The sharing of these materials does not establish an attorney-client relationship with the recipient and should not be relied upon as an alternative for advice from qualified counsel. Please note that facts and circumstances may vary, and prior results do not guarantee a similar outcome.

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