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Tech M&A Due Diligence Checklist: Critical IP Areas Of Inquiry

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Declining valuations are the backdrop of the current technology merger and acquisition landscape worldwide.

Such market downturns often lead to short deadline consolidation — and an accelerated timeline on a deal may increase the risk of peril. There are few things worse in an M&A transaction than signing a contract and discovering one or more of the following scenarios after closing:

- You don't own the intellectual property that you thought you were buying — and now you get to negotiate with a long-departed and unfriendly ex-employee over intellectual property rights, or in this day and age, the owner of an artificial intelligence generative tool that purportedly developed such intellectual property.
- You do in fact own what you thought you were buying, but a third party — ahem, perhaps major competitor? — already has a license to the technology.
- You own what you bought, but now you also owe a fair chunk of money to a third party because of a change of control trigger or because of an existing agreement with a university or government.
- Thanks to previous cyber breaches, your (new) employees' personal data and the product you bought is now out for sale on some dark web outpost.
- Your new company has been collecting data from its customers without consent and you discover the joy of answering very direct letters of inquiry from multiple states' attorneys general.
- The tax enforcer is knocking and asking unpleasant questions about prior equity valuations.
- You discover your new company sold its wares to less-than-savory governments or characters and now your favorite outside counsel is explaining to you the pros and cons of self-reporting these infractions — which, congratulations, are now deemed your infractions — to the government.

Oops. Sure, you can speed-dial your representation and warranty insurance broker for advice on financial recourse. But what do you do about the actual business? Time to reach for some antacid and then figure out how to brief your executive team.

It is of course best to avoid the above scenarios in the first place.

While due diligence may provoke eyes glazing over by investment bankers and business principals, it is a critical part of the acquisition process — and for technology acquisitions, there are several pitfalls to avoid.

Failure to promptly identify, assess and potentially mitigate specific issues during diligence can undermine the initial rationale for or valuation of the transaction.

Moreover, acquirors need to be careful in any assessment to have a pragmatic and accurate understanding of the issues — such that risks are accurately understood with precision and that an acquiror does not either casually dismiss risk on one hand, or conversely, potentially overreact to a hypothetical worst-case scenario that has a very low probability of coming to fruition.

A careful assessment of the target's practices and issues with respect to intellectual property is perhaps the most critical area of inquiry in technology mergers and acquisitions.

For most technology company targets, intellectual property is the bread and butter and a key value driver from the vantage point of a potential acquiror.

An important task in diligence is confirming that the target owns, or otherwise has the right to use, the intellectual property it purports to own. Issues may surface in a variety of contexts throughout the chain of title — from creation to subsequent transfers, to encumbrances via commercial arrangements.

While this article does not delve into every potential issue, as a general matter in technology deals, it is critical to understand what intellectual property rights the target actually owns, or has the right to use, the rights and obligations associated with, and the transferability, sufficiency and continuity of such intellectual property rights, as well as the extent and scope of any related encumbrances.

The following is a nonexhaustive list of critical areas of inquiry.

The Proprietary Information and Invention Assignment Agreement and Consulting Agreements

To ensure employees involved in the development of a target company's technology no longer own rights in the developments, and that the target has the full rights to exploit its technology, an acquiror will want to review the proprietary information and invention assignment agreement executed by each current and former employee of the target, or at least from each employee involved in the development of, or exposed to, the target company's technology.

Each agreement should include an express, current and future assignment of all rights, title and interest in inventions developed during employment.

Proprietary information and invention assignment agreements should also include confidentiality restrictions whereby the employees agree not to disclose proprietary information of their employer.

An acquiror must also confirm that founders and officers of the target have effectively assigned their intellectual property rights to the target company and that none of the proprietary information and invention assignment agreements or other inventions assignment agreements exclude intellectual property used in the target company's business as prior inventions.

If any such individuals have left the target company since its inception, to the extent that they were involved in material research and development efforts related to the target company's business, an acquiror will need to weigh the pros and cons of insisting that the target company seek to intellectual property assignment agreements prior to the signing or closing of the transaction.

Similarly, an acquiror should to evaluate whether all contractors and consultants providing research and development or design services to the target company effectively assigned to the target their intellectual property rights in the results or work product of the services.

Often, such consulting services are provided by engineering resources outside the U.S.

In such circumstances, an acquiror should consult with local counsel in the relevant jurisdictions to ensure that the operative inventions assignment provisions are enforceable under applicable law and that the obligations of the target are consistent with such local law.

Licenses and Encumbrances

Technology companies frequently enter into commercial arrangements with third parties under which the company's intellectual property is licensed, transferred or encumbered in some way.

An acquiror should pay special attention to agreements that cover research and development, joint ventures, joint development, collaborations, cross-licenses and other arrangements that license intellectual property, where parties covenant not to sue each other, or that may otherwise encumber the target company's intellectual property.

Key considerations include whether the license is transferable or sublicensable; exclusive or nonexclusive; limited geographically or worldwide; limited in duration, irrevocable or perpetual; and royalty-bearing or royalty-free.

License terms may include a "springing" license, whereby a counterparty is granted certain licensing rights upon a named event, such as a change in control or assignment.

If this springing license is triggered by the contemplated transaction, the acquiror may not receive all the rights to the intellectual property that it was anticipating, and instead, may have licensing or royalty obligations to a third party or even a competitor.

Similarly, the intellectual property may be jointly owned through a joint venture or similar collaboration agreement or subject to development milestones that trigger ongoing obligations or royalties to the counterparty even after the acquiror takes control.

The target company's intellectual property may also be subject to other distinct limitations, such as a covenant not to sue whereby the target agrees not to assert intellectual property rights against the counterparty for particular uses or products.

The Upward-Reaching Affiliate Issue

The issue of how affiliates is drafted in a target company's intellectual property license agreements should be carefully considered in the transactional due diligence context.

The issue is that the parties often fail to properly define the term "affiliate" or they define this term in a manner that is perhaps unintentionally overly-broad — e.g., includes any entity which controls, is controlled by or is under common control with licensor or licensee — such that, post-closing of the transaction, the license agreement could be deemed to apply to the acquiror's patent portfolio.

Consider, for example, the following scenario:

Company X enters into a license agreement for its entire patent portfolio with Company Y, in exchange for a license to Company Y's entire patent portfolio. The grant language provides: Company X hereby grants a worldwide, irrevocable, royalty-free, fully-paid up license to Company Y to exploit the entire patent portfolio of Company X and Company X's affiliates.

Thereafter, Company X seeks to merge with Company Z. Unbeknownst to Company X, Company Z entered into a license agreement with Company Y that provides a significant source of revenue to Company Z.

When Company Z merges with Company X, it also acquires the license agreement between Company X and Company Y. After the transaction closes, Company Y terminates its license agreement with Company Z, claiming that the license acquired from Company X includes the patent portfolio of Company Z, because Company Z is now an affiliate of Company X.

An acquiror generally would not expect to grant a patent license to third parties as a result of the consummation of an acquisition — in particular if such entity has a valuable patent monetization program or the beneficiary of the upward affiliate issue in a patent license agreement is a direct competitor of or is in litigation with such acquiror.

Transfer or Change in Control Restrictions

An acquiror will want to confirm early in the diligence process whether there are any "change in control" or anti-assignment provisions in the target company's intellectual property agreements that would prohibit or limit the ability to transfer the intellectual property in the manner contemplated by the parties.

Even if not expressly prohibited by a change in control clause, the parties should confirm that the transaction will not trigger any anti-assignment prohibitions in the target company's intellectual property contracts.

In general, intellectual property license agreements are deemed to convey rights that are personal to the licensor and non-transferable to a third party absent the consent of the licensor.

Thus, whether a transfer occurs by virtue of a given transaction or is permitted under the agreement without the consent of the licensor may be important to consider in the context of a material inbound IP license agreement.

Some courts have held that a transfer of contractual intellectual property rights in a forward merger constitutes an impermissible transfer that violates anti-assignment prohibitions.

While courts in most jurisdictions have generally found that a reverse triangular merger does not trigger an assignment by operation of law, the effect of a reverse triangular merger on anti-assignment provisions should be evaluated, especially if a contract is material.

This is particularly true in light of cases such as SQL Solutions Inc. v. Oracle Corporation, where in 1991, the U.S. District Court for the Northern District of California held that a reverse triangular merger could potentially trigger prohibitions on assignments by operation of law in certain circumstances.

Provided key issues can be identified early in the process, counsel can implement the necessary structure, and require the necessary consents, to ensure the acquiror achieves its desired result.

If a consent cannot be obtained or likely cannot be obtained, understanding the effect on the target company's business of losing the IP rights — or license fees or royalties associated with the procurement of a new license — will be important to assessing the deal's valuation.

Government or University Funding

Funding from government or university sources such as grants, or even the use of university facilities, can often come with strings attached, including ownership or license rights in favor of the funding source.

Applicable statutes, grant terms, faculty employment agreements and university policies should be carefully reviewed to confirm whether a university or government funding source has any consent or intellectual property rights in, or with respect to, the transfer or use of any of the target company's intellectual property.

Further, while during recent years, universities have become more supportive of their professors launching companies, not all universities have updated their policies regarding the same.

As a result, an acquiror may need to require a target to obtain certain consents or releases from a government or university funding source as a closing condition to a transaction.

Outside the U.S., government funding can create tail liabilities that need to be allocated between the acquiror and seller — for example, in Israel, exporting IP developed using in part funds from the Israeli Ministry of Innovation, Science and Technology for development outside of Israel could likely trigger a nontrivial payment.

Conclusion

This article considered the potentially material issues that may arise in the diligence process that are specific to intellectual property. Our next article will address additional technology specific legal diligence concerns in acquisitions.

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