by Angelique Kaounis

HIGH-TECH STAKES

In the acquisition of a technology company, counsel should focus business executives on the possibility of litigation if the deal falls through

IN THE TECHNOLOGY SECTOR, many contemplated acquisitions focus on one essential question—build or buy? To answer this question, the proposed acquirer must, by necessity, assess aspects of the target company's proprietary technology (which in most circumstances is highly confidential), such as scalability, integrity and complexity of software, long-term plans to enhance existing technology, and other important factors that contribute to the value of the intellectual property. This task generally cannot be accomplished without at least one knowledgeable technologist leading the inquiry and asking the right questions.

But what happens when "build" is the conclusion the technologist reaches? If a due diligence process has been carefully planned, a proposed acquirer's later development of a competing technology may not raise any concerns from either the former target's or acquirer's perspective. But if the diligence is not carefully mapped out or the possibility of future litigation has not been adequately considered by either party, the result can be costly to both.

Before diving into the diligence process for a planned acquisition of a technology company—particularly if the proposed acquirer is competing with a similar technology, developing a competing technology, or even just considering developing a competing technology—several fundamental factors should be examined. In particular, the prospective acquirer should look inward at its own development practices and outward at the anticipated due diligence process to educate and position itself for the possibility of litigation.

If the proposed acquirer were sued for alleged misappropriation, how would the company's existing processes, as well as the actions taken during the due diligence, support or undermine possible defenses that the company could assert? For example, if the potential acquirer

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were required to reconstruct the diligence process, would it be able to mount a credible defense of independent development or reverse engineering based on its own internal documentation and the makeup of its technology team? Or, would the composition of the proposed diligence team and the materials reviewed during the diligence compromise these positions? Also, when the process was over, could the prospective acquirer convincingly maintain that it no longer had access to the target company's materials? Careful planning of in-house development and external diligence processes can go a long way toward answering these questions.

Before entering into diligence with any possible target company, counsel for the proposed acquirer should be sure to understand the rationale for the proposed acquisition. This step not only assists in setting goals for the process but also serves a practical legal purpose. Simply put, legal counsel needs to know from the beginning that the proposed deal is worth the risk. Understanding the motivation for the deal is a central factor to running this calculus, because if a proposed acquirer initiates diligence for anything other than the stated purpose of acquiring the target company, and in the process gains access to the target's trade secrets, this could result in liability. For example, under certain versions of the Uniform Trade Secrets Act, a claim for misappropriation can include the wrongful acquisition of trade secrets even if they are never used.[1] Thus, to steer clear of such an avoidable situation, diligence counsel should ask the company's business and technology executives for samples of e-mail, internal presentations, and similar information that reflect the company's purpose in entering into the transaction.[2]

After coming to an understanding of the motivation for a proposed deal, the acquiring company's legal team should examine the status of the acquiring company's own development efforts, if any, on similar or competing technology. This means more than simply knowing that development efforts are underway. A substantive inquiry into the scope of the contemplated technology and development efforts—including whether the product or technology is in the concept, design, code-writing, bug-testing, or even beta launch phase—is required. This is an indispensable exercise because, in the event of litigation, evidence of a defendant's parallel development time line can often be key to establishing a defense of independent development.[3]

On this point, the importance of documentation cannot be overstated. Indeed, because documentation is often vital to establishing a defense of independent development or reverse engineering, it is essential for counsel to understand what documentation the client has to support its own development process, and what efforts, if any, are being taken (or should be undertaken) to preserve these materials.[4] For example, does the client have product plans documenting the evolution of certain technology or maintain a software "versioning" system, which allows developers to look back at prior iterations of the software? Should counsel conclude that inadequate efforts are being taken to preserve development documentation, he or she should consider educating the client's product development team about the importance of maintaining the material and implementing a recordkeeping requirement. One way to ensure that development information is maintained is to have the company adopt a versioning system for its software development processes. This system keeps archives (e.g., a wiki) of development documents. Employees may also be encouraged to keep lab notebooks documenting their research and experimentation.

Documentation can be helpful in tracking the in-house development process but also can be damaging to a defendant's case. For example, evidence of failed development efforts or documentation suggesting that in-house development proved too difficult, expensive, or time-consuming (or that it simply could not be done) can be particularly damning to a defendant in a trade secret action.[5] For this reason, it is crucial for counsel to ask whether the company has had difficulty in developing the product or technology at issue. If development has been difficult, counsel should understand why. Counsel should even consider interviewing management and development team members to understand whether any of them believe in-house development cannot be achieved, and if so why. While the company may not espouse the belief that in-house development cannot be achieved, evidence that any prominent employee involved in the due diligence or development process holds this opinion can sharply undercut a defense of independent development.

Similarly, because evidence of overlap between a due diligence team and competitive product development team can, in some states, support an inference of misappropriation or severely undermine the defense of reverse engineering, it is critical from the outset to understand who at the company is working on product development in the relevant area.[6] As part of this inquiry, counsel should understand how the client—specifically, the relevant business unit and its in-house technology team—defines "product development" and how it views those who participate in the process. At its broadest parameters, "development" ranges from conceptualizing to quality assurance and everything in between. This information is vital because it informs the entire process, including who should be involved in the diligence and what, if any, competitive sensitivities may arise during its course. Failure to understand these dynamics could result in the inadvertent inclusion of unnecessary personnel in the diligence process, with the further consequence that the company's later competitive development efforts could be delayed or thwarted altogether.[7]

Beyond examining the contours of the product development team and the status of any parallel development efforts, counsel should understand how the client treats its technology-related materials, and whether the client considers those materials to be trade secrets. The question as to whether a given plaintiff's material actually qualifies as a trade secret ultimately depends on whether it meets the relevant statutory definition of a trade secret. But if the client treats its own similar proprietary material as a trade secret, then it may be hard-pressed later in litigation to argue that it did not understand or expect the target's comparable information to also be a trade secret. This type of evidence could be especially compelling in the context of defending against a claim of willful misappropriation, which in many states could warrant the imposition of exemplary damages.[8]

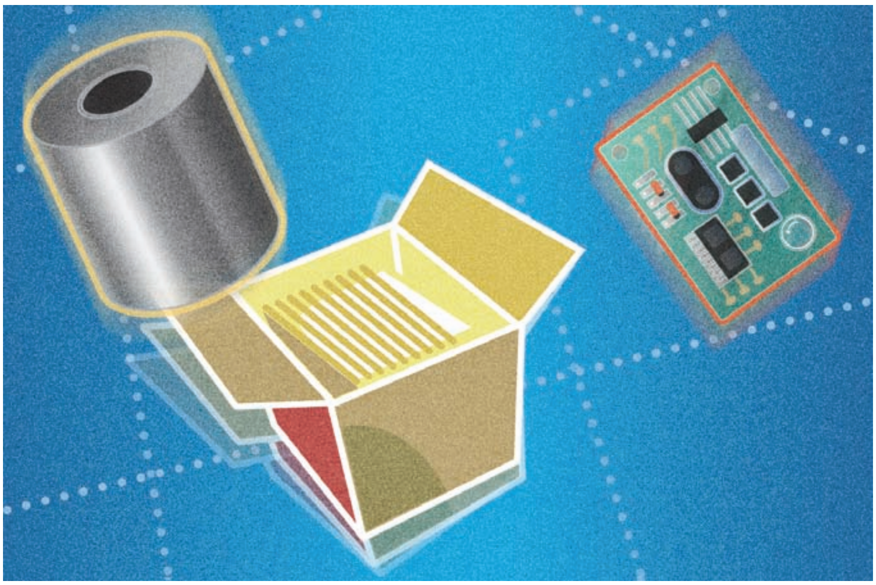
Finally, counsel should become familiar with the company's prior track record with trade secret litigation—including whether the company has ever been a plaintiff or defendant in a trade secrets case, and if so, which employees and technology were involved, and whether the company prevailed. If the company did not prevail, counsel should inquire into the reasons why the company's prior litigation position was unsuccessful and explore whether similar factual circumstances that bore on the outcome of the prior case still exist. Once the above factors have been considered, counsel can make more informed decisions about how to properly structure the due diligence process and minimize the risk of future litigation in the event that the deal does not go through.

Structuring Due Diligence

After gathering the information described above, counsel should be in a position to structure the rest of the due diligence in a way that meets the acquiring companies' needs, while mitigating potential exposure to litigation. In this structural phase of the planning, counsel should examine who, why, what, and how.

The first question to address is: who will be involved in the due diligence? This requires evaluating which employees need access to the potential trade secret information of the target company so that they may properly assess its value. Depending on the status of the acquiring company's development efforts with similar or competing technologies, the complexity of the technology at issue, and the contemplated use of the target company's technology—e.g., as a standalone versus add-on application—the company may need to include several technologists in the evaluation process. In building the team, counsel should make every effort to create a technology due diligence team that is not composed of members of the competing technology development team but does have sufficient understanding of the company's technology and goals in acquiring the target that it can assist in due diligence. Another alternative is to use a consultant (such as a trusted former employee) who can assess the target company's technology for purposes of the due diligence.

If such measures are not feasible, counsel should look for ways to reasonably limit the access of technology diligence team members to the alleged trade secrets. This step should be taken in order to demonstrate the acquiring company's careful handling of this information. For example, counsel may consider whether the legal team can physically monitor the technology due diligence, or whether access to technology documents can be monitored in some other way. Alternatively, if the acquiring company has a reasonable degree of confidence concerning the value of the proposed target and its intellectual property, the parties may consider doing the diligence in phases. In some cases, it may be feasible to do the preliminary technology diligence before signing a deal and then "deep dive" diligence between the time of signing and closing. This approach should be conditioned on the acquiring company's ability to get out of the deal in cases in which a material difference exists between what the target company represented in negotiations and what the technology actually is.



Next is the "why" of the process. Here, counsel should consider whether the goal of the diligence has been adequately described to team members. Preferably, this should be done in writing. For example, there should be a due diligence checklist or set of requirements that clearly explains the parameters and purpose of the inquiry—e.g., "we need to know if XYZ exists, and if the technology is compatible with ABC." If such a directive does not exist in memo format, even an e-mail record can be useful. In litigation, this type of documentation may serve as persuasive evidence against a claim of willful misappropriation, particularly in showing, for example, that the actions of a rogue employee were contrary to the specific directives given as part of the diligence. Similarly, an existing employee handbook or policy that clearly prohibits the use of confidential third-party or competitor information may be useful evidence to rebut a claim of willful misappropriation.

For the "what"—the potential intellectual property and its worth—counsel should determine whether the diligence team understands the governing definition of the term "trade secret." For most people, the term "trade secret" conjures up thoughts of the recipe for Coca-Cola or a top-secret computer program. Often, the governing law in the relevant jurisdiction extends well beyond these traditional notions of trade secrets to include such things as client lists or compilations of publicly available information.[9] Similarly, the concept of misappropriation can reach beyond conventional notions of the "use" of trade secrets. For example, using another's trade secrets to figure out "what not to do" can constitute a cognizable claim under the California Uniform Trade Secrets Act.[10] Thus, providing a brief explanation of these governing principles, usually agreed to per a choice-of-law clause in the nondisclosure agreement (NDA), along with a few instructive examples of what the company itself considers to be its own trade secrets, can significantly affect the level of care with which employees approach the diligence process.[11] Moreover, since some companies do not require each diligence team member to individually read and execute the NDA, counsel should consider using a mechanism that requires each employee to acknowledge the company's obligations under the NDA. E-mail provides a fairly streamlined method for making sure that (at a minimum) every member of the due diligence team is advised by counsel of the company's obligations.

The "how" is typically the most time-consuming and expensive part of the diligence process. Unlike the who, what, and why, this element requires the cooperation and agreement of the target company. Specifically, because a NDA almost invariably will govern the terms of the diligence process—and can be used offensively and defensively later during litigation[12]—it is critical for counsel to examine whether the NDA provides its client with the protection it needs.

Among the key provisions of the NDA that can affect the scope and strength of claims later asserted in an action against the proposed acquiring company are 1) a description of the alleged trade secret and 2) an expiration date regarding confidentiality. In the case of the former, while it is not necessarily dispositive in terms of defining the alleged trade secret in later litigation, a term describing the trade secret may assist in limiting discovery.[13] When a description is included in the NDA, the acquiring company need not agree that the material at issue is in fact a trade secret, and indeed would be well advised to include specific language requiring the target to acknowledge that no such concession is being made. In the case of an expiration date on the NDA, this term can be vital in either prosecuting or defending against a trade secret claim down the road.

From the plaintiff's perspective, a long expiration term can be evidence of a "reasonable measure" taken to maintain the secrecy of the alleged trade secret. Conversely, from the defendant's perspective, a shorter term can be probative of the fact that the plaintiff did not intend to maintain the secrecy of the materials past a certain time and that the alleged trade secret information should lose protection after that time.

The NDA also may be used to establish that the companies involved in the proposed transaction are operating on a level playing field in the negotiations. To this end, language to the effect that the contract does not create a fiduciary duty or give rise to an implied confidential relationship under state law can be inserted. Similarly, language confirming that the parties are sophisticated businesses negotiating at arm's length and that each has conferred with independent counsel is also useful. These clauses may be effective in opposing a claim that an acquirer somehow owed a heightened duty to the proposed target.[14]

Likewise, to prevent any later claims that the target was unaware of the acquiring company's development efforts in the relevant technology—and to possibly guard against a later claim of willful misappropriation—counsel should consider including language that expressly requires the proposed target to acknowledge existing development efforts by the potential acquirer and acknowledge that the potential acquirer may develop a competing technology if the deal falls through. The proposed acquirer should also consider including a term stating that it is not required to explain its reasons for deciding not to pursue the deal. While this seems like a less important term, it can provide the potential acquirer with additional security in knowing that it can simply walk away from the deal if it does not like what it sees.

Mapping the Paper Trail

The NDA is one persuasive document to help tell the diligence story, but it is far from dispositive. For this reason, counsel also need to think about the kind of paper trail the due diligence process will create. To this end, it is worthwhile to map out a plan for how the due diligence team will obtain, transmit, and share due diligence information. This plan should include not only materials generated and disseminated by the target company but also any assessments of the target company's technology or processes that are generated by the acquiring company's diligence team. Among available options are 1) an online e-data room with password protection, 2) an online sharing program (e.g., NetMeeting) that can be recorded by the host of the program, 3) on-site access or in-person meetings only, or 4) e-mail.

In the case of in-person meetings, counsel should consider whether minutes or recordings of meetings are advisable. In the case of e-mail, counsel should think about how e-mail transmission of due diligence materials would allow either party in a trade secret case to reconstruct the diligence time line to demonstrate who had access to which documents and when. In some cases, such as those in which a diligence team is small, e-mail can be useful to show the limited extent to which the information was shared. In other cases, however—such as those in which the diligence team is large—a client may be better off prohibiting e-mail transmission of diligence documents. When an e-mail ban is not a feasible solution, one practical and inexpensive method for managing (and perhaps minimizing) e-mail communications is to require that diligence counsel be copied on them.

Additionally, if the electronic information that a company receives is not truly restricted internally (e.g., by password protection or levels of access or use), the potential acquiring company could be vulnerable to criticism that it failed to comply with the NDA. Similarly, if there are hard-copy materials circulated during the diligence process, the acquiring company is well advised to store them in a locked or restricted location. Likewise, if diligence team members are permitted to take notes in meetings, these too should be kept restricted, and in an abundance of caution, employees should be advised not to share work product except with members of the team—and within the team, to share on a need-to-know basis only.

If the deal does fall through, the company that sought the acquisition ordinarily will be required to certify that it has returned or destroyed all confidential materials received from the proposed target within a specified time. Depending on the size of the diligence team and scope of materials distributed, this can be a daunting and time-consuming task, but the value of being able to convincingly demonstrate compliance with this term, should litigation occur later, can be incalculable.[15] To this end, counsel should implement a mechanism to ensure that employees return or destroy materials acquired through the diligence. E-mail with built-in response buttons affirming compliance is a useful tool that requires little effort on the part of the employee and that facilitates easy recordkeeping for NDA compliance. This measure can later serve as helpful evidence of a company's good faith efforts to comply with an NDA.

In anticipation of acquiring a company with new and innovative technology, business personnel may not be focused on the possibility of litigation should they decide to walk away from a proposed transaction. This is why the legal team needs to be thinking about these matters. Ideally, after considering the issues, counsel for the potential acquirer will structure the due diligence and the company's development processes in a manner that enables the company to actively pursue mergers and acquisitions without the fear that walking away will result in litigation. ■

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1 *See, e.g.*, Civ. Code §3426.1(b)(1); 12 Pa. Cons. Stat. Ann. §5302.

2 Evidence of ill will against a competitor can support a finding of willful misappropriation. *See, e.g.*, Elm City Cheese Co. v. Federico, 752 A. 2d 1037, 1056 (Conn. 1999).

3 *Compare* AEB & Assocs. Design Group, Inc. v. Tonka Corp., 853 F. Supp. 724, 734-35 (S.D. N.Y. 1994) (Idea submission case in which plaintiff failed to rebut evidence of independent development, and defendant conceived of idea behind the relevant product eight months prior to meeting with plaintiff.) *with* Ajaxo Inc. v. E*Trade Group, Inc., 135 Cal. App. 4th 21, 53

(2005) (Substantial evidence supported jury verdict finding misappropriation when, "within weeks" of learning of Ajaxo's trade secrets, "too short a time for independent development, Everypath implemented the same solution.").

[4] *See, e.g.,* Glaxo Inc. v. Novopharm Ltd., 931 F. Supp. 1280, 1304-05 (E.D. N.C. 1996) (independent development defense established by contemporaneous documentation in the form of research notes showing defendant's development efforts).

[5] *See, e.g.,* Miles Inc. v. Cookson Am., Inc., 1994 WL 676761, at *14 (Del. Ch. Nov. 15, 1994); Faiveley Trans. Malmo AB v. Wabtec Corp., 559 F. 3d 110, 118 (2d Cir. 2009).

[6] *See, e.g.,* Roton Barrier, Inc. v. Stanley Works, 79 F. 3d 1112, 1118-19 (Fed. Cir. 1996) (upholding finding of misappropriation where diligence and development teams overlapped); Nilssen v. Motorola, Inc., 963 F. Supp. 664, 683 (N.D. Ill. 1997) ("[T]he placement of key employees in a position where they might assimilate a trade secret permits an inference of misappropriation.").

[7] *See, e.g.,* Den-Tal-Ez, Inc. v. Siemens Capital Corp., 566 A. 2d 1214, 1220, n.3 (Pa. Super. 1989) (affirming three-year injunction barring Siemens from acquiring a business that competed with the plaintiff when there was overlap in the teams conducting diligence into the proposed target and the plaintiff, and when the trial court found that use of the plaintiff's confidential materials was "inevitable" if the acquisition were to take place).

[8] *See, e.g.,* Civ. Code §3426.3(c); 12 Pa. Cons. Stat. Ann. §5304(b).

[9] *See, e.g.,* Decision Insights v. Sentia Group, 311 Fed. Appx. 586, 594, 2009 WL 367585, at *7 (4th Cir. Feb. 12, 2009) (District court's failure to consider whether software compilation could qualify as trade secret required remand.); Therapeutic Research Faculty v. NBTY, Inc., 488 F. Supp. 2d 991, 999-1000 (E.D. Cal. 2007) (Plaintiff "adequately alleged that its username and passcode constitute a 'trade secret'" under Civil Code §3426.1(d).).

[10] *See, e.g.,* 02 Micro Int'l Ltd. v. Monolithic Power Sys., Inc., 399 F. Supp. 2d 1064, 1072 (N.D. Cal. 2005), *amended*, 420 F. Supp. 2d 1070, *aff'd*, 221 Fed. Appx. 996, 2007 WL 1107738.

[11] Generally, the parties negotiating a potential acquisition enter into a nondisclosure agreement (NDA) to specify the terms by which each party discloses confidential information and the scope of the receiving party's obligations with respect to that information. A typical NDA will provide that the parties may not use any confidential information disclosed by the other except for the purpose of evaluating the possible transaction.

[12] *See, e.g.,* Hoffman v. Impact Confections, Inc., 544 F. Supp. 2d 1121, 1125-26 (S.D. Cal. 2008) (Plaintiff did not present the court with any evidence that it "designated its ideas as 'confidential' under the terms of the Non-Disclosure Agreement" and thus was unable to satisfy the "reasonable efforts to maintain secrecy" prong of the California UTSA.).

[13] In California, for example, a trade secret plaintiff is required to "identify the trade secret with reasonable particularity" before "commencing discovery." Code. Civ. Proc. §2019.210. If an existing document already sets forth these parameters, it can be extremely valuable in defining the scope of the trade secret(s) at issue.

[14] *See generally* Nilssen v. Motorola, Inc., 963 F. Supp. 664, 679-80 (N.D. Ill. 1997).

[15] *See generally* Heyman v. A.R. Winiarick, Inc., 325 F. 2d 584, 591 (2d. Cir. 1963) (affirming dismissal of misappropriation claim where, among other things, defendant testified that he had discarded plaintiff's information after his firm had lost interest in purchasing the plaintiff's business).