Intellectual Property Department
21st September 2018.

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THE IMPORTANCE OF IP DUE DILIGENCE IN MERGERS AND ACQUISITIONS

Intellectual Property Rights (IPRs) now form a significant proportion of company assets due to modern innovative techniques as well as recent technological advancements. IPRs, which include trademarks, patents, and domain names, may be defined as any intangible creation of the human mind, which may be expressed or translated into tangible form in order to assign certain rights of property.[2]

An analysis of the Fortune 500 companies found that in 1975, 60% of their market value was represented by tangible assets. However, in 1995, this percentage dropped to just 25%.[3] Therefore, intangibles such as Intellectual Property (IP) assets have come to accrue a significant level of importance to individuals and corporate bodies. The value of IP is not dependent on physical components, such as size and structure; instead, IP is valuable because it represents ownership and in most cases an exclusive right to use, manufacture, reproduce, or promote a unique creation or idea. In this way, it has the potential to be one of the most valuable assets a person or a business can own. Therefore, the need to conduct a thorough IP due diligence when attempting to initiate M&A transactions should be of paramount consideration. In spite of this, research has shown that in the course of

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2 "Intellectual Property", (https://www.inc.com/encyclopedia/intellectual-property.html) accessed 15 August, 2018.

3 Adriana Tiron Tudor, Ştefana Dima, Bogdan Dima, Raluca Valeria Raţiu, "The Linkage between Intangibles and Intangibility", (http://www.oeconomica.uab.ro/upload/lucrari/1620141/25.pdf, 2014), 283.

conducting due-diligence in M&A transactions, lawyers and auditors tend to focus their efforts mainly on the ownership of the company, equity, company debt as well as the general physical structure of the company. Furthermore, "most intangible assets are not recognized in financial statements, and current accounting rules do not require firms to report separate measures for intangibles."[4] In doing so, corporate bodies and regulatory authorities inevitably pay little to no attention to Intellectual Property Rights.

IMPORTANCE OF CONDUCTING IP DUE DILIGENCE

The purpose of an IP due diligence is to identify any assumptions regarding valuations and where possible, to determine and quantify any related risks. The due diligence report may provide for several types of transactions including company mergers and acquisitions, asset sales, joint ventures, loans, secured transactions, and valuations, among other possibilities.

For potential buyers, information concerning the strength of a target's IP assets helps to assess any risks associated with the seller's IP portfolio and may determine whether the transaction is worthwhile. Therefore, unless a due diligence is conducted effectively, companies may be exposed to unknown risks and liabilities. For sellers, due diligence may improve the marketability of their company and allow them to identify weaknesses in their IP portfolio which might compromise a sale.

CONDUCTING A SUCCESSFUL IP DUE-DILIGENCE

When conducting IP due diligence, employed professionals may rely on a variety of approaches including the income and discounted flow methods. In order to ensure that these approaches are dutifully applied, certain factors must be taken into account. This article provides eight vital factors which must be taken into account when conducting a successful IP assessment.

Pre-Due Diligence Formalities

The first and foremost consideration to be addressed is the legal framework. This often commences in the form of a letter of intent or memorandum of understanding and commonly regulates the due diligence process.[5] A confidentiality agreement between the buyer and the target company is one of necessity and both parties should ensure that it is carefully drafted

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4 Feng Gu, Weimin Wang, "Intangible Assets, Information Complexity and Analysts Earnings Forecasts. Journal of Business Finance and Accounting", (2005), 32: 1673-1702.

5 Taylor C. Auten, Amy E. Risseeuw, "The Basics of an M&A Letter of Intent", (https://www.wyrick.com/news-publications/letter-of-intent-basics), Accessed 15 August, 2018.

to include the scheduling, *modus operandi* and deadlines, with due emphasis on attorney-client privileges.[6]

Create and Maintain an IP Register

All business enterprises should endeavour to maintain an up-to-date IP register. This is a clear demonstration to any investor of a well-managed business that recognises the value and importance of its Intellectual Property. Often this is limited to patents, trademarks and designs, but ideally copyrighted material and know-how should also be included.[7] The register should include basic information such as the application number and status of each IPR, as this is always the first piece of information which is requested when conducting IP due diligence.[8] A more sophisticated approach involves storage of a company's published trademark applications and granted patents in a data room.[9]

Utilize Experienced Personnel

Having established the need for an updated register as well as a well-drafted contract, companies must endeavour to employ the services of experienced counsel. The selected legal counsel must exercise a working knowledge of the primary product lines and future plans of the target in order to ensure that the team remains focused primarily on the IP assets which are relevant to the firm. When dealing with M&A transactions, it is highly important for counsel, which are usually Intellectual Property lawyers, to take all IPRs into consideration. It is a common misconception that patents are the most important IPR a company may possess when in actual fact, other assets such as the brand name stand on an equal and sometimes even more valuable footing.[10] For instance, the Coca-Cola "brand" alone is valued at US$79.96 billion.[11] Due diligence requires a significant amount of effort and the average transaction, even if dealing with relatively small businesses, requires

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6 Find Law, "Due Diligence and Protection of Confidential Information", (https://corporate.findlaw.com/law-library/due-diligence-and-protection-of-confidential-information.html), Accessed 16th August, 2018.

7 Kauffman," Understanding the Various Types of Intellectual Property", (https://www.entrepreneurship.org/articles/2006/08/understanding-the-various-types-of-intellectual-property, 31st July, 2006) Accessed 18th August, 2018.

8 Fiona Stevens, "The Importance of IP Due Diligence in M&A and Investment Transactions", (https://www.gje.com/the-importance-of-ip-due-diligence-in-ma-and-investment-transactions/, 18th January, 2016), Accessed 17th August, 2018.

9 Ibid.

10 Office for Harmonisation in the Internal Market "Intellectual Property Rights and Firm Performance in Europe: An Economic Analysis", (https://euipo.europa.eu/tunnel-web/secure/webdav/guest/document_library/observatory/documents/IPContributionStudy/phase2/executive_summary_en.pdf,June 2015) Accessed 16th August, 2018.

11 Statista, "Coca-Cola's Brand Value from 2006 to 2018 (In Billion U.S Dollars)", (https://www.statista.com/statistics/326065/coca-cola-brand-value/), accessed 12 August, 2018.

hundreds of hours of due diligence with help from appropriate professionals. They must ensure that every detail, however trivial, is taken into account.

Determine IP Ownerships

When conducting IP due-diligence, appointed counsel must clarify issues of undisclosed ownership. This is a common reason why M&A transactions fall through.[12] Therefore, all inventors must be correctly identified and the chain of title must also be clearly documented. Furthermore, the necessary assignments should be well executed and where appropriate, registered. Without proper investigation into a company's Intellectual Property assets, an investor may find, after the conclusion of the transaction that either it does not possess ownership of the sought after IP assets or that they have been transferred or restricted by third party interests.

This was an unfortunate consequence of the Volkswagen-Rolls Royce Acquisition. In 1998, Vickers Plc (owners of Rolls-Royce) decided to sell Rolls-Royce Motors to Volkswagen Group for £430m. As part of the deal, Volkswagen Group acquired the historic Crewe factory, plus the rights to the "Spirit of Ecstasy" mascot and the shape of the radiator grille. However, the Rolls-Royce brand name and logo were controlled by aero-engine maker Rolls-Royce Plc, and not Rolls-Royce Motors. The aero-engine maker decided to license the Rolls-Royce name and logo to BMW and not to Volkswagen, largely because the aero-engine maker had recently shared joint business ventures with BMW. BMW paid £40m to license the Rolls-Royce name and "RR" logo, a deal that many commentators thought was a bargain for possibly the most valuable property in the deal. Volkswagen Group had the rights to the mascot and grille but lacked rights to the Rolls-Royce name in order to build the cars, likewise BMW had the name but lacked rights to the grille and mascot.[13]

Another closely related case that underscores the need to accurately determine value and IP ownership is the Google-Motorola acquisition. In 2011, Google purchased Motorola's mobile phone business for USD 12.5 billion. It based its decision to purchase on the manufacturer's patent portfolio of around 17,000 patents. To the surprise of the technology market, Google sold the business to Lenovo after only two years, although it retained most of the patents in order to defend its overall Android ecosystem.[14] In an interview with Forbes,[15] Don Harrison,

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[12] Ivona Skultetyova, "Intellectual Property in Mergers and Acquisitions: Deal Maker or Deal Braker", (http://arno.uvt.nl/show.cgi?fid=129082, June 2012), Accessed 17th August, 2018.

[13] Bentley & Rolls-Royce | The Ultimate In Luxury Cars, (https://isuperdrive.com/blog/bentley-the-ultimate-in-luxury-cars/), Accessed 14th August, 2018.

[14] Ibid.

Google's head of mergers and acquisitions, stated that despite the sale of Motorola to Lenovo at a lower price, Google still came out on top. He explained that the basic idea was that the sale of Motorola's home business, cash on hand, deferred tax assets and the $2.91 billion Google received from Lenovo meant that in the end, Google paid less than $3.5 billion for Motorola's patent portfolio, which it retained after the sale. Motorola's 17,000 patents was the "cookie" Google was trying to obtain, they were really not interested in the company hence the sale to Lenovo.

Identify Any Harnessing IPRs

It is important to identify potential sources of income which may not have been harnessed. For instance, since 2003, IBM has made US$1 billion yearly on licensing non-core technology, which would have remained unused.[16]

Identify Litigation Risk

The due diligence counsel must identify assets which may pose a legal liability to the company subsequent to an acquisition. For instance, employing top management employees from a first-tier company might be a litigation risk due to the fact that such employees might have signed non-disclosure agreements and may possess key information regarding R&D and company trade secrets.

Disclose What Is Essential and Refrain from Proceeding without Relevant Information

The main difficulty in conducting due diligence lies with accurately pre-defining the scope of information to be reported as well as the level of detail to be disclosed. A good example is The Daiichi–Ranbaxy deal. In 2008, Daiichi had bought the Singh brothers' 34.82% stake in Ranbaxy for $2.4 billion. The total deal value was $4.6 billion.[17] Problems emerged soon after the acquisition, when Ranbaxy's plants came under scrutiny by the US Food and Drug Administration (FDA). It was later discovered that a 2004 self-assessment report meant for the company's internal use, showed how the company was misrepresenting data and Malvinder Singh was aware of this information. Ranbaxy did not reveal the internal report, or its contents, to Daiichi at the time of the 2013 deal, which was a sign of bad faith. In 2013,

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15 Miguel Helft | A Peek at Google's M&A Ambitions, (http://fortune.com/2014/02/12/a-peek-at-googles-ma-ambitions/), Accessed 21st September 2018.

16 "Module 10: IP Audit", (http://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_10_learning_points.pdf), Accessed 13th August, 2018.

17 Rajesh Srivastava, "Six Business Lessons from the Daiichi-Ranbaxy Deal Fiasco", (https://www.livemint.com/Companies/ABxz5axWTnk7EmtdNF7GxN/Six-business-lessons-from-the-DaiichiRanbaxy-deal-fiasco.html, 31 May,2016), Accessed 14th August, 2018.

Daiichi filed an arbitration case against Ranbaxy in Singapore. The firm had accused the Singh brothers of concealment and misrepresentation of relevant facts. Daiichi claimed that they would not have paid any price for the Ranbaxy shares, had they been aware of the self-assessment report. The former owners of Ranbaxy Laboratories Ltd., were ordered by a Singapore arbitration tribunal to pay $385 million to Japanese pharma company Daiichi Sankyo Co. Ltd., which had bought the firm in 2008.[18]

It is important to always disclose relevant and truthful information in M&A transactions as the "*caveat emptor"* (buyers beware) principle will not be available as a defence if there is proof of concealment and misrepresentation. In this circumstance an aggrieved party may be entitled to damages.

Conducting IP Valuations

Arguably the most important step in the IP due diligence process is the IP valuation. This is the most precarious aspect when it comes to dealing with M&A transactions as there is no specific formula to IP valuations. Additionally, financial auditors have not helped in this regard as accounting methods tend to undermine the value of intangible rights and IPRs.[19] IP valuations must include all IPRs and intangible rights like goodwill, employee know-how, instilled employee skill and expertise etc. It is important to consider not only the present value of the IPRs but also their future value.[20] An IPR for instance might lose its value in 3 years while a presently unharnessed asset may yield immense profits for the company in 3 years.

RISK FACTORS WHICH MUST BE TAKEN INTO ACCOUNT DURING IP DUE DILIGENCE

Following a merger or acquisition, certain external factors may emerge and derail the viability of newly acquired assets to the detriment of the existing company. Therefore, when evaluating the profitability of a potential IPR, counsel must take some of these factors into account.

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18 Reuters, "Japanese drug maker Daiichi wins damages from former Ranbaxy owners", (https://www.reuters.com/article/us-ranbaxy-daiichi-sankyo-idUSKCN0XW19K, May 15, 2016), Accessed 15th August, 2018.

19 Kelvin King, "The Value of Intellectual Property, Intangible Assets and Goodwill", (http://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html), Accessed 15th August, 2018.

20 Ibid.

New Patent Issuance

New patents could either make existing technology obsolete or, more likely, allow for another competitor in the same space. If a similar patent is issued the value of the underlying technology will most likely decrease.

Patent Challenges

An issued patent remains open to attack for invalidity, and it is a common defence for an alleged infringer to assert that the patent is invalid. Typically, patents are challenged on the grounds that an entity, other than the named inventor developed the claimed property; that the invention is "obvious" to persons skilled in the relevant technology, or that the patent is mundane and bears similarities with existing technology.[21] Successful challenges can immediately invalidate the patent and corresponding licenses. In principle, proper due diligence should reveal these potential problems.

Foreign Regulations

Companies must take the utmost care when merging with internationally based companies because IPRs are treated differently in various countries.

CONCLUSION

When dealing with start-ups or companies at any level, it is important to always emphasize the importance of protecting their IPRs. Purchasing companies must understand the benefits of undertaking effective IP due diligence and in the event of an acquisition, acquired companies must conduct due diligence prior to transactions in order improve their marketability and enable them to identify weaknesses in their IP portfolio which might hinder or compromise a sale. When properly protected and administered, IP can drive a business forward and generate significant revenue for its bottom line. As such, companies must ensure that their IP portfolio is well protected, correctly catalogued and ready for due diligence if an exit strategy is anticipated.

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[21] Alex Harding, "Shedding Light on the Obviousness of Gene Patents", (https://jolt.law.harvard.edu/digest/obviousness-gene-patents, 16 January 2018), Accessed 16 August 2018.