

## “IT in the Current M&A Market”

*By: Brandy Milazzo*

M&A activity appears to be returning to, and may even exceed, levels seen in the middle of the last decade, if the effects of the financial meltdown do not continue to haunt us. As one commentator has noted:

“If 2010 was the year in which mergers and acquisitions got back off the mat, 2011 could be the year in which it starts throwing haymakers. Global M&A has totaled \$309 billion since January 1, according to data from Thomson Reuters. That’s a 69% jump over the same period in 2009, and represents the busiest start since 2000.”<sup>1</sup>

In the new era, key characteristics of M&A activity have changed. At an ever-increasing pace, transaction value will derive from information technology. Yet, with tighter access to financial markets, Acquirers face little room for error. Since studies have shown that many M&A deals fail to achieve their primary goals, parties now pay more attention to diligence, which, during times of intensive dealflow, was often relegated to junior associates as a mere checklist item. Thus, with technology becoming increasingly important, technology due diligence is a top priority.

In early stage planning, the Acquirer should identify its immediate business objectives (*i.e.*, to acquire new technology, new or complementary products, employees, technical knowledge, trademarks, channels, sources, or other intellectual property rights), as well as its long-term strategic goals. To accommodate a short-term exit strategy, for example, the acquired intellectual property assets might be assigned to the same subsidiary that acquires title to the tangible assets, in order to simplify a future divestiture, rather than assign the intellectual property to a subsidiary whose sole purpose is to own all the affiliated entities’ intellectual property rights. Additionally, the scope, and thus the expense, of due diligence should be weighed against the transaction’s strategic importance. Although expensive, due diligence is crucial to the discovery of “landmines.”<sup>2</sup>

If a transaction fails to close, the Acquirer’s employees might retain their knowledge, gleaned during diligence, of the Target’s valuable proprietary information. The Acquirer could

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<sup>1</sup> Dan Primak, “Gonna be a blockbuster? M&A off to best start since 2000,” *Fortune*, February 4, 2011, <http://finance.fortune.com/2011/02/04/gonna-be-a-blockbuster-ma-off-to-best-start-since-2000>.

<sup>2</sup> Schwartz, William I., “Intellectual Property Issues in M&A and Other Corporate Transactions: Watching Out for the Not-So-Obvious Pitfalls,” Section of Business Law, American Bar Association Annual Meeting, August 11, 2003.

be left at risk for misuse of such information, such as claims for misappropriation of the trade secrets of the Target or its competitors, as well as an increased risk of treble damages for patent infringement, if knowledge obtained during diligence serves as the basis for a “willfullness” finding. Therefore, the Acquirer should enter into a nondisclosure or standstill agreement with the Target that addresses permitted use of disclosed information, as well as permitted recipients.<sup>3</sup>

In conducting intellectual property due diligence, a lawyer will focus on the *intellectual property rights*, rather than the *subject matter* of those rights. *Intellectual property rights* are patents, copyrights, trademarks, and trade secret rights. The *subject matter* of such rights includes, but is not limited to, software, semiconductor designs, product specifications, methods, processes, documentation, etc. In short, any product, invention, idea, material, or information may be protectable under intellectual property laws. A single asset might include multiple intellectual property assets or *subject matter* from a legal perspective. For example, proprietary software (a) may be a copyrightable as a whole, (b) may include algorithms, code, methods or processes that might be independently patentable, (c) may include internal designs and internal documentation that constitute trade secrets, even if not patentable, and (d) may well be associated with brand names or logos that constitute trademarks. The distinction between rights and subject matter is also important to help the Acquirer remain focused on the *positive or value and the negative or limitations* of intellectual property. Acquirers should avoid focusing only on the *positive or value* of intellectual property, while ignoring the *negative or limitations*, such as infringement or misappropriation of third-party intellectual property rights, which may be derived, for example, from title defects at any point in the *chain* of ownership or from prohibitions on assignment in present or prior transactions.<sup>4</sup> An Acquirer should also keep in mind that express or implied licenses might be granted in agreements that are not titled as *license agreements*, such as distribution, manufacturing, development, joint venture, consulting, and settlement agreements.

Critical items to be examined are the *chain of title* of owned assets and the *assignability* clauses of *licensed* assets. Common examples of *chain of title* problems include (a) ineffective assignments of rights under “work made for hire,” because legal tests were not met, (b) lack of consideration in invention assignments, (c) lack of specificity with respect to assignment documents (particularly with catch all phrases such as “all rights *necessary*” for a particular purpose or license), and (d) failure to grant the licensee a right to sue third parties for infringement. For each significant license, the Acquirer should consider: (1) Does the license agreement contain any provisions regarding assignment, change of control, and similar issues? (2) Do such restrictions apply, given the contemplated structure of the deal? (3) Outside of the transaction agreement, what rules govern the transfer of this licensed asset? Whether a license contains restrictions is, of course, evident from examining the text, although provisions that indirectly affect assignment should be considered. Whether the transaction structure constitutes an assignment or change in control under the agreement’s definitions (or lack thereof) or governing law may not be facially evident. Share purchases generally do not trigger non-assignment clauses<sup>5</sup>, but may be blocked by an express change of control provision or in a

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> See, e.g., *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1<sup>st</sup> Cir. 1997).

“sham” transaction specifically intended to assign a license.<sup>6</sup> Similarly, a reverse merger (including a reverse triangular merger) in which the licensee survives does not usually trigger a non-assignment clause.<sup>7</sup> However, a merger in which the licensee does not survive does trigger a non-assignment clause. As one court has explained, “[a] transfer is no less a transfer because it takes place by operation of law rather than by a particular act of the parties. The merger was effected by the parties and the transfer was a result of their act of merging.”<sup>8</sup> Since judicial decisions turn on a transaction’s facts, there are decisions contrary in result, pointing to the intellectual property subject matter, the fine points of the applicable state merger statute, the federal preemption deference, specific licensure provisions, and equitable considerations, such as whether the subject matter will be owned by a competitor.<sup>9</sup>

Governing law might contradict the license agreement or itself be unclear. For example, some rights are governed by federal common law (e.g., patent licenses and copyrightable subject matter), while other rights are governed by state law (e.g., trade secrets), and some rights involve both federal and state law (e.g., trademark licenses). Moreover, rights under an exclusive license may be viewed differently than non-exclusive rights. Other issues to consider are the existence of noncompetition commitments, most favored nations obligations, and open source software complications.<sup>10</sup>

A consulting firm found that, while 50 to 60 percent of its clients’ M&A activity was intended to capture synergies related to technology, most technology issues were not fully addressed during the diligence process or post-deal planning.<sup>11</sup> An Acquirer that prioritizes and focuses its technology and intellectual property due diligence from the planning stages of a deal will no doubt recover more value, mitigate risks, and achieve greater goals. This is particularly true if the Acquirer’s key information technology personnel are involved in the early planning stage, in coordination with the Target’s counterparts, since discovered information might be too technical to be properly interpreted in a legal review. Thus, the Acquirer may gain a superior bargaining position in negotiating meaningful representations, warranties, and indemnifications that address identified intellectual property risks.

*Brandy Milazzo is a partner in the corporate practice group in the Charlotte, North Carolina office of Shumaker, Loop & Kendrick, LLP.*

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<sup>6</sup> See, e.g., *In re Alltech Plastics Inc.*, 5 U.S.P.Q.2d 1806 (Bankr. W.D. Tenn. 1987).

<sup>7</sup> See *Hartford Empire Co. v. Demuth Glass Works*, 19 F. Supp. 626 (D.N.Y. 1937); but see *SQL Solutions v. Oracle Corp.*, 1991 U.S. Dist. LEXIS 21907 (D.D. Cal. 1991).

<sup>8</sup> See, e.g., *Cincom Systems, Inc. v. Novelis Corp.*, 581 F. 3d 431 (6<sup>th</sup> Cir. 2009), citing *PPG Industries, Inc. v. Guardian Industries Corp.*, 597 F.2d 1090 (6<sup>th</sup> Cir. 1979).

<sup>9</sup> See *Id.* at fn. 2.

<sup>10</sup> *Id.*

<sup>11</sup> “Understanding the strategic value of IT in M&A”, [https://www.mckinseyquarterly.com/Corporate\\_Finance/M\\_A/Understanding\\_the\\_strategic\\_value\\_of\\_IT\\_in\\_M&A](https://www.mckinseyquarterly.com/Corporate_Finance/M_A/Understanding_the_strategic_value_of_IT_in_M&A).