

# Intellectual Property (IP) Diligence



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**An important factor for an investing company is to understand the investee company's IP and the potential economic value locked in its intangibles. IP diligence exercise provides information on the nature and strengths of the intangible assets by studying the rights or IPRs associated with those assets.**

An organization's intrinsic value is dogged largely on the quality of its assets and not on its quantity. Further, such value also largely depends on that perceived by its various stakeholders – shareholders, creditors, government, consumers, etc. Conventionally, physical assets have been responsible for the bulk of the value of an organization, and were also considered to be largely responsible for determining the competitiveness of an enterprise in the market place. However, in today's information and knowledge-based economy, this customary wisdom no longer holds true. All organizations have some form of intangibles in the form of intellectual property ("IP") regardless of their size, nature or sector. Many IP stakeholders have only recently realized the value of the IP and rights related thereto and thereby try to unlock its latent value.

In cross-border transactions, investing companies often land up making significant investments in acquiring IP of

an investee company. An IP diligence exercise can help such investing companies not only in understanding various kinds of IP an investee company holds but also in ascertaining the various risks and liabilities attached to the IP as well as ascertain the maximum potential worth of the IP.

IP is now one of the most valuable assets in any commercial transaction, whether joint venture, M&A, manufacturing, purchase and distribution arrangements, etc. Apart from the exploitation of IP by their own use, companies also earn huge revenues through IP licensing. For example, IBM generates bulk of its revenue from patent licensing. The importance of IP is being increasingly felt over a wide spectrum of industries globally. This article tries to emphasize the significance of conducting IP diligence and identify various legal challenges that may arise when an investing company based in one jurisdiction invests in the IP of another entity located in another jurisdiction.

## Undertaking IP Diligence

An IP diligence exercise provides an assessment of the intangibles of an investee company and helps to examine and evaluate the strengths and weaknesses in the procedures used to protect each intangible asset and secure appropriate IP rights. Where necessary, the diligence provides tools to develop additional processes, make improvements to existing processes and take corrective measures to help ensure capture of future IP rights.

- The investing company may undertake IP diligence in a number of instances before investing in an investee company which may include acquisition of a product, brand or technology; sale of a business enterprise for the purpose of IP valuation; to detect various risks, defects and liabilities; and to keep updated with changes in the legal environment.

Once the IP diligence objective is identified, it is easier to establish what type and nature of diligence exercise has to be undertaken, i.e. whether the diligence has to be general, specific or comprehensive. For example, in M&A transactions, a comprehensive diligence may be appropriate if an investor is contemplating an acquisition of a substantial ownership interest in a business or its assets.

## Important Considerations

Some of the major important steps that must be borne in mind by the investing company while undertaking an IP diligence include:

- Review company's internal policies and procedures

It is very important for the investing company to know about investee company's internal policies and procedures with respect to identification, creation, protection, management and enforcement of IP. Lack of these may result in irreparable damage to the investing company at a later stage. Mismanagement of IP at the point of its creation may often lead to time consuming and unnecessary costs and efforts

to prove the ownership of IP. Investing company may also face IP infringement proceedings from third parties, if proper diligence is not exercised. Further, the investee company may also have substantial amount of information in the nature of confidential information and trade secrets. Apart from understanding the way in which the IP is safeguarded, the diligence team must also analyze the procedures adopted by the investee company in educating its employees regarding use and dissemination of such information. For example, certain information may be confidential for company's marketing department, but it may not be so for other departments, say production or finance.

It is, therefore, very crucial to review such policies and procedures as a part of the IP diligence process. This process may eventually help in establishing an IP strategy for the investing company.

- Procedure for finalization of agreements

An investee company may have entered into various agreements with various parties such as employees, partners, contractors, vendors, freelancers, etc. It is always advisable that at least one senior member from the legal and/or technical side, as the case may be, is present before the agreements are reviewed, negotiated and signed. The IP diligence team can review the procedures adopted by the investee company when such agreements are finalized as this will help in understanding the scope of the obligations, liabilities and rights of the investing company under the agreements post investment.

- Review of Agreements

The diligence has to review various contracts to which the investee company is, or has been, party to. This will assist in establishing whether any IP has been created under any agreement, and if yes, who owns the rights to the same, how is the IP exploited, etc. Documents to be reviewed should include contracts/agreements with consultants,

contractors, freelancers, employees, joint development agreements, research & development agreements, IP licensing and IP assignment agreements, transfer of technology agreements, distribution agreements, marketing or co-branding agreements, franchise agreements, etc. Such review and analysis helps to ensure that the agreements contain clauses assigning the IP developed by the employees to the investee company and obligations relating to confidentiality and non-compete.

Reviewing litigation related documents will help in ascertaining and examining IP disputes pending with various local or foreign courts or before any international authority such as the WIPO. Description of all claims and pending or threatened litigation, arbitration, administrative and regulatory proceedings by or affecting the investee company, it's current or former directors, officers or employees should also be examined. All correspondence relating to IP disputes, cease and desist notices, affidavits, letters alleging infringement, letters threatening lawsuits, complaints for copyright infringement, details of opposition proceedings initiated with regards to registration of IP should also be examined carefully. IP litigation and claims often involve important aspects of the business and the outcome of such disputes can have a significant impact on the investing company's viability.

IP diligence helps the investing company to take decision whether to continue with pending litigation or not. In cases where there is little chance of success, the same can be aborted or settled, to save future time and expense.

- Review of documents recording registration of IP

These documents are examined to ascertain the correctness of the information recorded on various IP registers. For example, in case of trade mark (the correctness of the name of the owner, correctness of description of goods and services and classes), in

case of copyright (correctness of the name of the author and the holder of various rights in the copyrighted work), etc. This is most important in case of group companies. It is often found in group companies that no conscious decision is taken regarding the ownership of IP while registering it. This leads to conflicting or concurrent rights being recorded, creating legal complexities and also problems at the time of hiving off of one of the group companies or its major division or in cases of M&A. For example, if each member of a group company registers the same trade mark in its name, then that leads to ownership of same trade mark by various entities. Multiple ownership for a single trade mark is generally an antithesis of concept of trade mark globally.

Once the review has been done, the diligence team must ideally conduct a formal database search at the IP Offices to validate their finding as well as to understand the actual factual position.

- Issue of IP Diligence Report

The report states the objective of the diligence, the diligence plan and how it was executed and the results of the analysis. It describes and evaluates defects uncovered in the audit, proposes and describes specific remedial action that needs to be taken or that has been taken and responds to any other specific need the parties commissioning the diligence may have.

If the diligence was conducted in the context of an M&A, the report should provide the information necessary to decide whether the rights available are the rights required by the investing party, and should provide a basis for valuing the rights to be acquired. Necessary remedial action can be implemented either before the transaction is consummated or after the acquisition by way of condition precedent or condition subsequent.

#### Typical Issues Identified in Diligence

- IP Ownership Issues:** The investee company may need to cure defects in title to various IPRs



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that are discovered in the diligence. Assignments of ownership may need to be checked and recorded with the appropriate authorities. Further, necessary affidavits, no-objection letters, etc may be required to be obtained from co-authors / co-inventors. For example, an investee company's designer may have designed and developed a certain design/product which may be used by the investee company or which may form part of company's product portfolio. The investee company must get the said design/product and all rights related thereto assigned in its name.

Some diligence may also reveal deficiencies in license rights from third parties to make derivative works that incorporate elements of works owned by such third parties.

The diligence team should look into products that the investee company has developed through JV with other companies or research institutions. For example, to make sure that all those who contributed to any subject matter covered by the claims of patents covering such products is listed as an inventor, the diligence team should review potential contributions by past and current employees in all departments even incidentally connected to the development of the subject matter.

In India, as per the Indian Copyright Act, an employer does not own the inventions of its employees in the absence of a contrary agreement; either an actual assignment or an implied assignment must be found to support company ownership of such inventions.

The diligence may also reveal third parties who may be able to claim joint ownership with the investee company of an IP and who, by virtue of such joint ownership, will be free to exploit the IP themselves without the permission of the investee company. The investee or the investing company may need to buy out such joint owner's rights and interest. If the joint

ownership concerns a copyright, the law will imply a duty of accounting of profits to the other joint owner from the exploitation of the joint work by the investee company. If the investee company does not wish to buy out the rights of the joint owner, a written agreement may be needed in which the joint owners specifically agree that neither shall have a duty of accounting of profits to the other as a result of exploitation of the copyrighted work.

Any error in IP applications may need to be similarly rectified.

- IP Infringement Issues:** If the diligence reveals infringement or potential infringement of third party rights, say a patent, necessary licenses may be sought or the product may be redesigned 'around' the patent that covers the product or technology that may be the trade secret, or copyrighted work of another may be removed or redeveloped.

In transaction related diligence exercises, if it appears that consummation of a proposed acquisition will precipitate a lawsuit, it may be possible to obtain the necessary indemnification from the investee company.

- Other Issues:** If the future value of a product depends heavily on retaining certain key personnel, some potential problems can be avoided by developing contractual or other incentives for such personnel to stay on. If the key employees will not stay with the investee company after an acquisition, then appropriate consulting agreements, non-disclosure agreements or non-compete covenants may lessen the severity of their departure.

However non-compete agreements to a large extent are not enforceable in various jurisdictions such as India. If there are important contracts preventing the



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assignment of key rights, it may be possible to secure the consent of all involved.

Prospective legal, marketing and research and development strategies can be designed to minimize the exposure from defects discovered in the diligence. For example, if an early software version is in the public domain and cannot be copyrighted, future exposure may be reduced by immediately registering later or newer versions. Similarly, if no patent protection was sought for key areas of technology, potential protection may be available for improvements and advancements to such technology.

#### Conclusion

Today, an important factor for an investing company is to understand the investee company's IP and the potential economic value locked in its intangibles. IP diligence exercise provides information on the nature and strengths of the intangible assets by studying the rights or IPRs associated with those assets.

An IP diligence can be a relatively simple exercise that can have a meaningful role in avoiding various circumstances. It also serves as a guiding tool for the investing company, and often for the investee company, for maintenance, management and safeguarding of IP rights. Refer the Annexure as guidance to capture IP and rights related thereto.

As companies and investors understand the value of the intangibles and rights associated thereto, the amount of investments in IP based companies is bound to grow significantly. As a result the role of IP diligence has a long way to go.

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ANNEXURE

	INTELLECTUAL PROPERTY (IP)				
	Patents	Trademarks	Copyrights	Designs	Confidential information
Nature /Type of IP	?	?	?	?	?
IP created by	?	?	?	?	?
IP creation date	?	?	?	?	?
IP expiry date	?	?	?	?	?
Is the IP registerable?	Y/N	Y/N	Y/N	Y/N	Y/N
If YES (Y), is it registered?	Y/N	Y/N	Y/N	Y/N	Y/N
Is the IP in use?	Y/N	Y/N	Y/N	Y/N	Y/N
Where is IP used?	?	?	?	?	?
Can it be further exploited? eg, through royalty, licensing, etc	Y/N	Y/N	Y/N	Y/N	Y/N
Is the IP being commercially exploited?	Y/N	Y/N	Y/N	Y/N	Y/N
Do contracts exist? a) with employees b) with contractors	Y/N Y/N	Y/N Y/N	Y/N Y/N	Y/N Y/N	Y/N Y/N
Who / Which department is responsible for its protection?	?	?	?	?	?
Who / Which department is responsible for its management & enforcement?	?	?	?	?	?
What is the current approx. value of IP?	?	?	?	?	?

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