

Noli IP Newsletter

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Intellectual Property Issues in Corporate Finance Transactions: A Corporate Lawyer's Perspective

By David Peteler

Intellectual property issues are important in many types of corporate transactions, and particularly in financing and mergers and acquisitions transactions. With the IP portfolio of a company

portfolio of the Target was an important deal term. Noli IP Solutions, PC was the IP counsel in those transactions. Through a good understanding of each other's needs and concerns,

My goal in this brief article is to give IP lawyers a brief idea of how the corporate lawyers view these transactions, and give corporate lawyers a brief lesson in IP due diligence, so the attorneys can work more efficiently with each other to close a transaction.

seeking to close such a transaction (the "Target") often comprising a significant portion of the Target's value, due diligence and proper legal attention to IP issues are critical to a transaction.

In 2014 I had the pleasure of working on two corporate finance transactions, specifically two private placements, in which the IP

we were able to close the two financings smoothly.

My goal in this brief article is to give IP lawyers a brief idea of how the corporate lawyers view these transactions, and give corporate lawyers a brief lesson in IP due diligence, so the attorneys can work more efficiently with each other to close a transaction.

NEW ADDITION: Ms. Monica Hernandez

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Monica Hernandez is a Colombian licensed attorney who obtained an LLM degree in International Intellectual Property Law at the Chicago-Kent University. She was first introduced to Ms. Noli in Chicago by her mentee from the Hispanic Lawyers Association of Illinois, Mr. Reynolds.

Thanks to Noli IP Solutions PC's participation in the American Bar Association ILEX program, we are pleased to be the sponsors of Ms. Hernandez. She has been working from our San Diego Office since August 1, 2015.

Ms. Monica Hernandez can be reached via email at monica@noli-ipsolutions.com. We are truly excited to announce that Monica has joined our Noli IP team.

A. Goals of IP Review and Due Diligence

In financing and acquisition transactions involving public companies, the buyer or financier tends to rely on SEC filings, so the IP due diligence process is more streamlined.

In a private company transaction, IP due diligence takes on greater importance, and careful drafting of the applicable provisions (such as representations and warranties, indemnities, and limitations on liability) becomes more important. A potential private financing, merger or acquisition transaction requires at a minimum an understanding of the overall goals and process of the transaction as well as a solid due diligence review of the Target's IP.

From the point of view of the buyer and financiers, the assessment of the IP portfolio of the Target is important for at least these reasons:

1. Identifying the IP assets to see if they constitute what is desired or needed out of the transaction;
2. Identifying IP liabilities and exposure in closing the transaction;

3. Identifying IP obstacles to the transaction in advance, to allow time for mitigation prior to closing; and

4. Validating the business case and projected economics of the transaction.

B. The Transaction Process

To give the IP lawyer a sense of context and the process of a transaction of the kind discussed in this article, from the corporate finance lawyer's point of view the transaction will generally have four phases:

1. Preliminary Negotiations and Term Sheet. A Term Sheet (or Deal Memo, or Letter of Intent) sets out the major terms of the deal, after preliminary negotiations by the principals. The Term Sheet generally includes the structure of the deal (stock purchase, merger, asset acquisition); the key assets of interest; the price and economics; and a general statement that "this is subject to negotiation of final documentation, containing provisions that are standard for this type of transaction, and acceptable by counsel for both parties."

2. Due Diligence. Counsel for the buyer or financier will typically start the due

diligence process by sending Target's counsel a due diligence request list, stating the information and documents sought prior to completing the transaction. Due diligence request lists are frequently updated and additional requests are made as the due diligence process goes on.

3. Drafting the Final Agreement. Usually during the due diligence process, counsel will begin drafting the transaction agreements. These will be revised and honed as the due diligence process brings IP issues to light, and as the business negotiations are completed. Typically this will culminate in a set of transaction documents that will be signed, though the closing will not occur until certain conditions have been completed after signing. There may be post-closing obligations as well. While the corporate lawyer will draft the basic agreement, the IP lawyer will play a critical role in due diligence, identifying IP risks, preparing IP schedules, and co-drafting important IP-related provisions.

4. Closing. The transaction agreements will define the

conditions that must be completed before the transaction is “Closed.”

Typically money and assets or stock change hands at this time, although there may be post-closing conditions and obligations that must be complied with. Sometimes the signing and the Closing are simultaneous.

Since the due diligence process is critical to finalizing the transaction agreements and closing the transaction, it is important to know what due diligence is typically done in such a transaction. The specific items to be reviewed will change with the context and complexity of the transaction, and industry segment of the Target, but should include at least the basics listed below.

C. Basic Issues of IP Due Diligence

1. Ownership. Establishing that the Target has ownership or valid licenses to the IP is the obvious starting point. This process includes review of the underlying documents. Buyer’s or financier’s counsel will require representations and warranties regarding ownership from the Target. In many cases, a memo or opinion letter from IP counsel

will be very important, if not required by the buyer or financier, particularly if the Target owns or licenses IP registered in foreign countries. Both P and corporate counsel should expect the need for at least four schedules: a schedule of the Target’s patents and patent registrations; a schedule of the Target’s trademarks and trademark registrations; a schedule of the Target’s copyrights and copyright registrations; and a schedule of IP that the Target licenses from other parties. Other schedules, such as foreign design registrations, mask work registrations, and internet domain name registrations (not technically IP rights but often included in IP schedules) may also be appropriate. Problems may arise in the case of unregistered IP; the Target may wish to exclude it from a schedule of owned IP, because of the difficulties of proving ownership.

2. Sufficient IP for the Target’s Business. The buyer or financier will want to be sure that the IP listed on the schedules is sufficient for the Target to conduct its business as currently operated and as planned to be operated as

described in any private placement memorandum, business plan or other disclosure document (“Disclosure Documents”) provided to the buyer or financier as part of the transaction. If it is not sufficient, the Target will likely need to describe its plan for developing or obtaining the necessary IP.

3. Liens and Encumbrances. If there are liens or security interest on IP assets, they should be identified, and mitigated if possible. Security interests in IP may be filed in the USPTO or the US Copyright Office, and may also be filed as part of a UCC-1 filing. Judgment liens are another item to check.

4. Infringement. IP infringement litigation is costly and to be avoided if possible. For buyers and financiers, an IP infringement risk may be a deal breaker. Counsel will be concerned with:

a. Infringement by the Target of third party IP rights. Due diligence on this topic includes patent searches (which are expensive and may be worked around), interviewing the Target officers to see if they are

aware of infringement on third party IP rights, such as communications from third parties alleging infringement, law suites threatened or filed, and letters from patent or other IP counsel discussing potential infringement issues.

b. Infringement of Target IP by third parties. Whether or not the Target chooses to take action against a third party infringer, the infringement should be disclosed.

5. IP Agreements. If the Target has any IP agreements, including licenses granted by the Target of the Target's IP as well as licenses the Target has obtained to use another's IP, counsel will want to consider several issues, including: (i) confirmation of ownership of the IP at issue; (ii) the scope of the license and use rights, and whether it is sufficient for the intended purpose or need; (iii) exclusivity, non-exclusivity or other restrictions on the IP rights; (iv) ongoing warranty obligations that the Target may need to fulfill and potential costs; (v) appropriate indemnification provisions; (vi) confidentiality provisions; (vii) termination provisions; (viii) change of control provisions; and (ix)

whether there are any restrictions on sale or assignment of the IP agreement, and how to comply with those restrictions.

6. Royalties. A critical aspect of the Target's IP agreements is any royalty, commission or similar obligations, including (i) amount and duration, (ii) whether the payment obligations current, (iii) whether the payment obligations are subject to change, and (iv) whether they have been properly included in the target's financial statements and projections, and hence the transaction price.

7. Source Code.

a. Target Ownership of Source Code. The old gold standard was for a Target to own its own source code. This is still desirable, as ownership allows the Target to continue to develop its software, or incorporate its software into other software, creates barriers to entry, and also removes much doubt from potential infringement actions. If the Target owns its source code, counsel will want to determine of any source code is held in escrow,

and what the terms of the escrow are.

b. Open Source Software.

In recent years, open source software has become the new standard of development. For open source software, the buyer or financier will want to know all the licenses applicable to the open source software. IP counsel should expect to prepare a schedule of the applicable open-source licenses and copies of those licenses.

8. Employee Agreements. All employees, and independent contractors to the extent possible, should, at the time of their engagement, be required to execute a written IP agreement, assigning to the Target all IP they create during their employment or within the scope of their consulting agreement. If this was not done at the time the employees or contractors were engaged, the problem will need to be remedied before closing. Employees and consultants should also sign written confidentiality and non-disclosure agreements that will protect the IP. These agreements should also contain prohibitions on use of the Target's IP and trade secrets by employees or

consultants post-termination; this is particularly important in jurisdictions such as California, where covenants not to compete are not favored.

9. *Transfer Issues.* Counsel should consider the form of the transaction and the applicable IP transfer requirements. Generally, in a purchase of the Target's stock, the Target survives and there is no assignment of the IP assets. In a forward merger, the Target ceases to exist, and hence the IP will be assigned. In a reverse triangular merger, since the Target survives as an entity, the question of whether an assignment of the IP assets has occurred must be reviewed under state law. In an asset purchase transaction, issues of valid transfer of the IP elements must be identified

and resolved. For example, an intent-to-use trademark applications cannot be assigned until the USPTO has received evidence that the applicant is using the mark in US commerce, subject to certain exceptions. If an IP license is silent on assignment, exclusive licenses are generally assignable by the licensee without the licensor's consent, but non-exclusive licenses are not; again state law must be consulted.

10. *Privacy and Data Security.* The buyer or financier will be concerned with whether the Target maintains adequate internal policies regarding collection, use and protection of personal information.

D. Conclusion

This article is intended to give both the IP lawyer and the

corporate finance lawyer a basic understanding of the issues involved, and the transactional context in which these issues arise; and provides a non-exhaustive list of factors to be considered in a financing, merger or acquisition transaction involving IP assets. There are many other potential issues on both the corporate and IP side, which can be complex, and all such transactions require the joint cooperation of experienced IP and corporate counsel. It is hoped that, based on this background information, both IP and corporate counsel will be able to work better together to perform due diligence, negotiate, draft, and close these transactions.

IP Holding Companies: Like Living in Paradise?

By Mariana Paula Noli and Monica Hernandez

As many of our clients, you may wonder if setting an IP Holding Company (IPHC) is the right move for you and your business. Whether it is like living in a paradisiac island, a place where your company is not as heavily taxed, or its

assets are afforded an extra layer of protection or the administration of its assets is easier as it would otherwise, the answer to this particular question is not as simple and will vary depending on many factors and circumstances

surrounding your enterprise.

So let's talk about an IPHC.

An IPHC is a company which owns IP rights, isolated from another company with which the IPHC has direct or indirect

equity links. Every IPHC has a promoter, generally an operating company, which is primarily engaged in production, sales and services. Once the IPHC has been formed, the promoter does not step out of the transaction and continues to be involved in its management by taking part in strategic decisions.

IPHC are particularly successful in the area of e-commerce. Multinational e-businesses establish direct or indirect affiliates whose main purpose is to hold IP rights and to charge royalties, commissions, marketing expenses, manufacturing costs and fees for advertising services and technical assistance to the subsidiaries of the group. While it is true that the IPHC may be created for various reasons, one of the most common purpose is to mitigate the income tax burden through the location of the IP holding company. Its tax advantage justifies the payment of a substantial fee by the operating company to the holding

company in exchange for the taxation of revenues at a lower rate in an offshore jurisdiction which would otherwise be taxed at the higher rate of the country of the operating company.

The dictionary definition of a **tax haven** is a state, country or territory where, on a national level, certain taxes are levied at a low rate or not at all. It also refers to countries which have a system of financial secrecy in place, which can be used by foreign individuals to circumvent certain taxes (such as inheritance tax on money, and income tax of the interest on the money you have on your bank account).

To this date, many jurisdictions have been considered at "tax havens" such as Switzerland, Luxembourg, Ireland, Netherlands, Jersey, Isle of Man, Bermuda, British Virgin Islands, Cayman Islands, Delaware, as well as Puerto Rico. Tax havens change throughout the years but when setting up

one of these IPHC, keep in mind that the state of domicile of the holding company must be tax-friendly as regards the collection of IP revenues as well as the distribution of dividends, especially so as to avoid withholding taxes. A suitable holding company jurisdiction will not tax such dividends or capital gains, and so net earnings can be reinvested in new ventures, either in the holding company jurisdiction or abroad.

Other factors to be considered in making a determination as to whether an IPHC would be a right fit for your business are the easy administration of the intellectual property rights as well as the protection of the IPHC's assets. An IPHC allows a company to centrally organize and manage all the intellectual property of the corporate group. The greater the number of operating companies, the greater the need for centralized registration, maintenance, and enforcement of the group's

intellectual property. Consolidating these services in-house enables a company to reduce reliance on outside legal counsel and thereby cut costs and improve internal efficiencies.

Another important legal benefits of an IPHC is that it allows a company to

quarantine its intellectual property from claims against the operating companies exploiting it.

Given these many benefits, among others, the formation of an IP Holding Company to manage and maintain a company's intellectual property is a

step more business owners should look into pursuing.

Please feel free to contact our office at mail@noli-ipsolutions.com should you want more information on the process of incorporation of an IPHC or the level of protection afforded by the same.

Trademark Workshop at the Universidad de Palermo

During the 2015 Design Expo at the Universidad de Palermo, Ms. Luciana Noli gave a workshop on "Trademarks: characteristics and the registration process in Argentina," which was held on Wednesday, July 29, 2015 in Buenos Aires, Argentina. We take this opportunity to congratulate Ms. Noli as well as Ms. Cernadas from our Buenos Aires office on the successful seminar. To obtain a copy of this presentation, please email us at luciana@noli-ipsolutions.com.

