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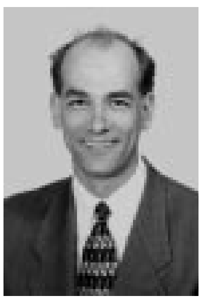
This newsletter is provided with our compliments. Its purpose is to inform our readers of developments within the firm and in the legal field of intellectual property law. We invite your comments, questions, and opinions.

Intellectual Property Due Diligence in a Business Transaction

by Christopher Lewis and Kevin Goldstein



Intellectual property (IP) due diligence can be defined as the process undertaken by an acquiring company to evaluate a target company's IP assets. In a transaction involving the sale of a business, IP due diligence involves a review of a target company's patents, trademarks, copyrights and trade secrets pertaining to that business. As shown in the illustration, the ultimate end result of business transactions is an acquiring company's purchase of a target company's IP. Although the focus of this article is an acquisition from an acquiring company's point of view, a number of the considerations discussed below are equally important in other types of business transactions and may also be used by a target company in marketing itself.

An example of IP due diligence can be found in the story of one of the greatest technological advances of the 18th century. That advance resulted from Sir John Harrison's efforts to develop a timepiece accurate enough to aid in correctly determining a ship's longitude. He was motivated by the Longitude Act of 1714, in which the British Parliament pronounced that a "king's ransom," £ 20,000 at the time, would be granted to anyone who solved the problem of determining longitude to within one-half of a degree. The Longitude Act specified only that a "practicable and useful means" of determining longitude be created for the Board of Longitude to grant the reward, but did not expressly require that the "means" be reproducible. Towards the end of Sir John Harrison's efforts, however, the Board of Longitude took great pains to ensure that the new timepiece could be reproduced, asking him for a written description of how to make the watch and hiring another watchmaker to replicate it. The board recognized the value of being able to make the watch and, in effect, asked Sir John Harrison to show the board members and the public his trade secrets used to make the watch. Sir John Harrison complied and ultimately was awarded the prize.

In today's world, business transactions occur much more rapidly than the nearly forty years which it took Sir John Harrison to satisfy the Board of Longitude. Given today's accelerated time frame for business transactions, it is even more important to initiate the IP due diligence exercise early in the negotiations and thereby gain certain advantages. First, an early assessment might allow more time for an acquiring company to identify any shortcomings in a target company's IP portfolio. Uncovering certain facts might improve the bargaining position of the acquiring company. In addition, an early start to the process is more likely to permit the acquiring company to focus on the key areas in the target company's IP assets. Thus, a greater percentage of the available resources can be devoted to those areas of consideration most important to the acquiring company.

In conducting an IP due diligence study, a checklist can be a helpful starting point. Table I is a checklist of selected action items according to one approach that an acquiring company might undergo in its IP due diligence study. A more expansive checklist can be

(continued on page 2)

IN THIS ISSUE:

Intellectual Property Due Diligence in a Business Transaction

(continued from page 1)

obtained by contacting Ratner & Prestia. As with any form or checklist, the checklist of Table I must be used with appropriate considerations. In some cases, given certain budgetary constraints for both money and time, this checklist may be too extensive. In other cases, it might not include entire topics critical to a certain business transaction. Nonetheless, a checklist is a helpful starting point, and it is worthwhile to elaborate on the action items listed in Table I.

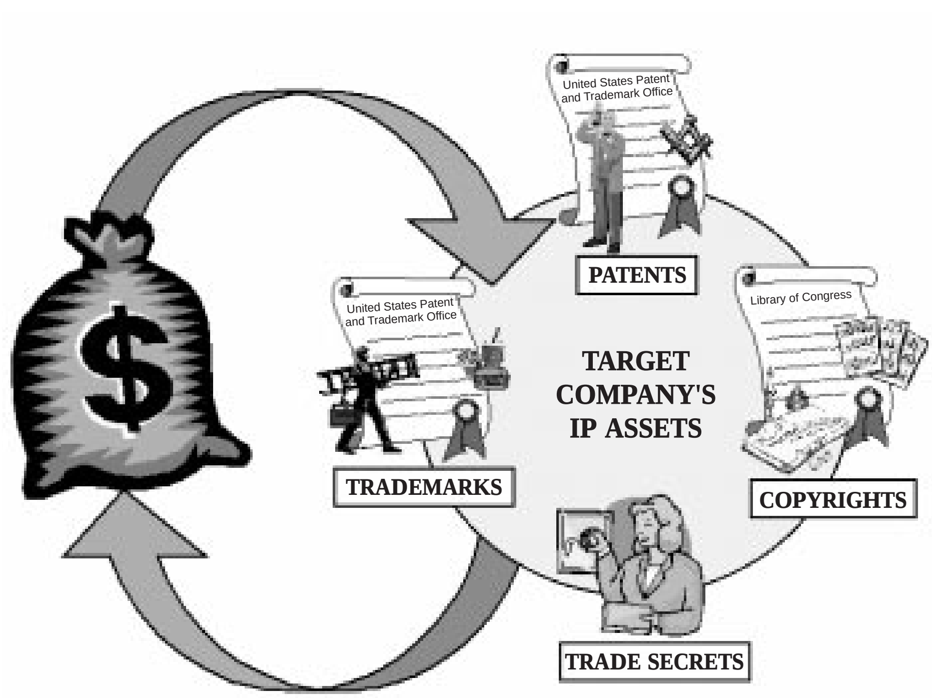
A logical due diligence first step is for the acquiring company to have the target company list all of its IP assets to be sold so that the acquiring company can identify the pool of IP assets. This list might take the form of appendices identifying all of the patents, patent applications, invention disclosures, trademarks and service marks (both registered and common law), copyrights, copyright registrations and trade secrets. The status and geographical scope of each of these IP assets should also be included. Along these lines, the acquiring company should ask itself when certain patents might expire and whether the target company has protected certain IP assets in the most important markets.

The acquiring company should then confirm the completeness of the initial listing provided by the target company to better define the boundaries of the pool of information. For example, an acquiring company should conduct a search by assignee of the patent and trademark offices of the relevant countries. A related entities search, a search by inventor and a subject matter search might uncover additional IP assets which should have been included in the initial listing or, if owned by third parties, which might adversely impact the ability to commercialize certain products. With respect to trade secrets, technical personnel of the acquiring company should review all products and identify any trade secrets which would be needed to continue the business, such as processes for making certain products or intermediates to certain products.

The next action item listed on Table I refers to ensuring that the target company holds clear title to the IP assets. With the completion of this step, any outstanding liens or security interests in the IP assets should be uncovered. A check of only the records of the Library of Congress should uncover any such liens or security interests against registered copyrights. With respect to patents and federally registered trademarks, however, it is worthwhile to review the results of the Assignment Branch search of the U.S. Patent and Trademark Office and a search of the relevant UCC offices to identify the filing of any security interests. This is true despite a recent case by a Bankruptcy Appellate Panel of the Ninth Circuit which concluded that filing in the relevant UCC state office was sufficient to perfect rights in a security interest of a patent.

The next two action items on Table I, identifying licenses, permit the acquiring company to identify any expansions or contractions to the pool of information. For a license of a third party's property, the acquiring company should review the terms and ensure that they are consistent with the envisioned use of the licensed assets. It is important to ensure that any trademark license includes the required quality control provisions and that these provisions are followed. In addition, in the event of a trade secret license, the acquiring company should confirm that the license agreement obligates all parties involved to take reasonable measures to keep the information secret.

Having undertaken a review of the first five action items shown in Table I and now having a better sense of the target company's IP asset pool, the next due diligence task is to focus the review to obtain



The transfer of money from an acquiring company to a target company in exchange for the intellectual property (IP) of the target is the impetus for due diligence activity. The most prevalent forms of IP are patents, trademarks and service marks, copyrights and trade secrets. IP due diligence by an acquiring company allows evaluation of a target company's IP assets which are often critical to the decision of whether to purchase the target company.

Table I

Selected Action Items in an IP Due Diligence Study

1. Identification of IP Assets
2. Confirmation of IP Asset Identification
3. Confirmation of Clear Title
4. Licenses to Target Company
5. Licenses from Target Company
6. Focus on Key IP Assets
7. Identification of Other Third Party Rights
8. Liability to Third Parties
9. Claims Against Third Parties
10. Evaluation of Target

Table II

Four Important Dues and Don'ts

- Early intervention of due diligence analysis may add value to your business transaction and may augment the acquiring company's negotiation position
- Always give due consideration to the critical aspects of the acquisition (why is this "deal" good for the company?)
- Always be cognizant of, and give due consideration to, the practicalities of budget, including both time and money
- Do not approach a due diligence analysis with a narrow mind

a more detailed understanding of the key IP assets. This entails a more discriminating review of any key patents, trademarks, copyrights and trade secrets and should be undertaken to ensure that the important assets are valid, enforceable, maintained and generally protected as necessary to maintain the value of the asset.

For patents and trademarks, this may entail confirming the validity and enforceability of the key IP. In the patent area, if there is a particularly significant product being commercialized by the target company, the acquiring company should confirm that one or more of the listed patents cover the product and cannot be easily designed around. For trade secrets, this task may require identification of the critical personnel who have knowledge of any key trade secret and whether appropriate restrictive covenants are in place to protect the loss of that knowledge. Similarly, it may be advantageous to determine if the trade secret knowledge can be transferred to other personnel in case the identified critical personnel decide to leave the target company.

The next three tasks listed in Table I are a review of some matters that may affect the value of the property, including either diminishing or augmenting the IP value. First, research should be undertaken to determine if any other third party rights exist in relation to the IP. Such rights may take the form of agreements, including those with universities or government agencies, such as SBIR agreements. With respect to copyrights, an area of heightened importance in recent years is whether software or website developers who have created computer code for use by the target company may have retained copyright ownership of the work. Such restrictions in copyright could severely restrict use and exploitation of the IP by the acquiring company.

The value of the target company may also be affected if any liability to third parties exists. This liability may manifest itself as the purchase of an infringement or misappropriation lawsuit asserted by such third parties. The target company should be required to disclose all actual and potential liabilities of which the target company is aware. In addition, the acquiring company should also consider analyzing the results of the searches referred to above to assess further whether any liability exists.

Similarly, the target company's value may be influenced by the potential assertion of the target's IP against infringing third parties. For example, a patent infringement lawsuit or potential claim against a target company's competitor may result in an injunction against the competitor or an advantageous license arrangement. On the other hand, given the uncertainties of litigation, the target company's patent may be found invalid or unenforceable. If that occurs, and the asserted patent was a key property right in the acquisition, then the value of the target company would be significantly diminished.

In the trade secret area, it may be critical to review how the target company develops its products and technology. If technology is "created" through the hiring of employees from the target company's competitors, who may be under confidentiality agreements, the target company may be facing a charge of misappropriation of trade secrets. Similarly, as noted above, a review of the restrictive covenant and confidentiality agreements of the target company's key personnel may identify a potential problem of critical technology and knowledge leaving the target company after the acquisition.

The third area of research is directed to understanding the target company's policies and procedures for protecting its IP. Often the procedures, or the lack thereof, relating to patents, trademarks, copyrights or trade secrets become apparent as a consequence of undertaking the earlier due diligence tasks. Even if the target company appears to have valid and enforceable patents, it is helpful to ensure that maintenance fees and annuities are appropriately docketed and timely paid. Similarly, if the target company has research laboratories, it is helpful to review whether researchers' notebooks are properly maintained.

The value of a business today has clearly expanded beyond the tangible "bricks and mortar." The value of a company's intangible IP often far exceeds the value of its tangible property, and is, in many transactions, the reason for the acquisition. As such, a proper due diligence review of the IP assets of a proposed target is not just helpful but may be critical to ensure that the acquiring company is in fact purchasing what it believes the target has to offer.

As explained in this article, and as highlighted in Table II, there are at least four important "do's" to consider when commencing an IP due diligence review. Of these four points, the most important in many cases is that a proper due diligence review of IP should not be undertaken at the last minute, but should be commenced early in the review of the target company. Such early review may assist in refining the true value of the target company. Although a thorough due diligence analysis will always provide more information about the target company, due consideration should be given to the always present limitations of time and money.

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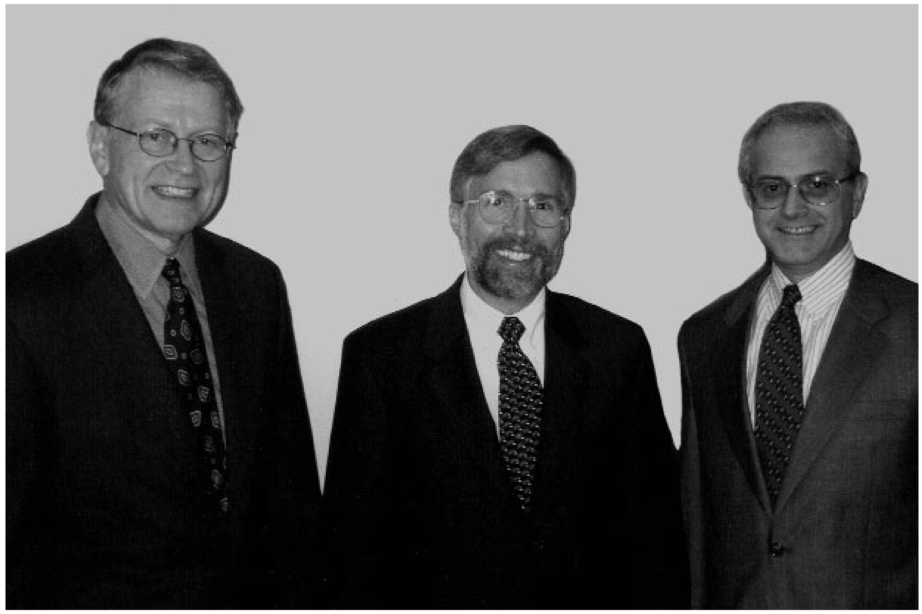
Speaker's Forum

• Costas Krikelis lectured at the University of Delaware on IP protection of computer software, with an emphasis on the process and mechanics of obtaining patent coverage. Costas is the managing shareholder in R&P's Wilmington office.

• At the Spring Meeting of the Licensing Executives Society (U.S.A. and Canada) (LES) in New York City, Chris Lewis and Kevin Goldstein led a workshop which was moderated by Andy Ney. The workshop, entitled "Intellectual Property Due Diligence in Preparation for Business Transactions," used three hypothetical business acquisition scenarios to highlight various important steps that an acquiring company may undertake as part of an IP due diligence investigation before purchasing a business. That workshop led to the lead article of this issue of INSIGHT. LES is an association of nearly 5,000 members involved in the licensing and transfer of intellectual property and is part of Licensing Executives Society International.

• Kenneth Nigon and Joshua Cohen conducted a Claims Drafting Workshop as a part of the Patent Prosecution Basic Training seminar hosted by the American Intellectual Property Law Association (AIPLA) in Arlington, Virginia. The Claims Drafting Workshop provided interactive training for the drafting of patent claims for electrical, software, and mechanical inventions and was attended by about 90 practitioners. Joshua is currently Chair of the Patent Legislative Committee of the Philadelphia Intellectual Property Law Association. ■



Ken Nigon is the third R&P shareholder to be elected to the Presidency of the Philadelphia Intellectual Property Law Association. Both Paul Prestia (right) and Allan Ratner (left) have served in this honored position. Congratulations to Ken.

Announcing

Kevin Casey appeared on CNN® to discuss a trademark and unfair competition case against the author and publisher of the popular Harry Potter series of books. This is one of many appearances Kevin has made to discuss the case in which the firm represents Nancy Stouffer who has authored a number of children's books. Kevin is lead counsel in that case.

Publications

• As reported in the last issue, The Bureau of National Affairs, Inc. (BNA) has published a treatise titled *Electronic and Software Patents: Law and Practice*. In addition to the work of Allan Ratner and Kevin Casey, Ken Nigon wrote Chapters 1 and 5. The book was written to help not only the patent prosecutor and the patent litigator, but to aid the general practitioner, the corporate executive, the corporate counsel, or any other person who needs a resourse on electronic and software patents.

• One of R&P's newest scientific advisors, Camille Jolly-Tornetta, PhD, has co-authored two recent papers. In the June 27, 2000 issue of *Biochemistry*, Dr. Tornetta co-authored the article, *Regulation of Amyloid Precurser Protein (APP) Secretion by Protein Kinase C in Human Ntera 2 Neurons (NT2N)*. A second article has been approved for publication in an upcoming issue of *Biochemistry*, entitled, *Protein Kinase C Regulation of Intracellular and Cell Surface Amyloid Precursor Protein (APP) Cleavage in CHO695 Cells.*

Win Your Domain Name Dispute Without Suing

You have been operating your small business for 10 years, and now you decide that you want to be on the web. You contact Netowrk Solutions, Inc. (NSI) to register your domain name, SMALLBUSINESS.COM, which is identical to the trademark you have owned for 10 years, SMALLBUSINESS. Unfortunately, NSI tells you that another party has already registered the domain name SMALLBUSI-NESS.COM, so you may not have it, even though it is identical to your trademark. After checking the Internet and discovering that the domain name is not being used, you contact the other party, who quickly offers to sell you the unused domain name for $5,000. What do you do?

On January 1, 2000, The Internet Corporation for Assigned Names and Numbers (ICANN), the non-profit organization that controls domain name registrations on the Internet, implemented an arbitration program for just this sort of conflict. Anyone who discovers that their trademark is being used as a domain name in bad faith by another party can take advantage of this relatively low-cost and speedy quasi-judicial proceeding to attempt to remedy the situation.

The procedure is relatively simple. First, a complaint is filed with an arbitration service provider selected by ICANN. Currently, in the United States, the only approved service provider is Arbitration Forum, but ICANN hopes to approve more in the future. Filing fees are between $750 and $2000. The complaint must contain all the facts pertinent to the case, including the names and addresses of the parties, proof of ownership of the trademark, and evidence that the defendant is using your trademark as a domain name in bad faith. The defendant then has 20 days from the filing of the complaint to respond. Once the response is received, a one or three person panel, depending on the choice of the parties, will review the filed papers and issue a ruling. The ruling should be issued no longer than 10 days from the appointment of the panel, which should be no more than two months from the filing date.

The remedies are limited. The panel can decide to leave the domain name as is, or transfer the domain name to the complainant. The panel has no power to do anything else, such as order money damages or injunctions.

The critical element of the arbitration program is that the complainant must prove that the defendant has acted in bad faith. This can be shown in a number of ways, but the most common is to show that the domain name registrant has requested payment for the domain name in excess of his or her out-of-pocket expenses in acquiring and maintaining the domain name (i.e. has engaged in cybersquatting). There are other acts, however, that could be considered bad faith, such as registering a domain name that is identical to a trademark to intentionally disrupt the business of the trademark holder, or to misdirect the trademark holder's customers.

For those on the receiving end of an ICANN complaint, a showing of good faith usage of the domain name, such as a legitimate business use, can be used to rebut an allegation of bad faith usage. This is exactly what occurred in BUYERS CHOICE v. BYER'S CHOICE, an ICANN Domain Name Dispute filed in January of this year. This was one of the first ICANN arbitrations held in the United States under the new policy, and the first in which the respondent answered the complaint and contested the allegations. Byer's Choice was successfully represented by Ratner & Prestia through the dedicated work of Christopher Lewis and Matthew Cohen.

Byer's Choice, located in Chalfont, PA, is a highly successful manufacturer of collectibles such as those sold under the "Carolers®" trademark. R&P has represented Byer's Choice for many years. In order that they not lose a customer who innocently misspells their name, Byer's Choice registered the domain name BUYERSCHOICE.COM as well as BYERSCHOICE.COM. Byer's Choice was accused of bad-faith use of the domain name, BUYERSCHOICE.COM by Buyers Choice, a real estate services company located in Washington state. Byer's Choice was able to prove to the arbitration panel that it registered BUYERSCHOICE.COM in good faith, as many people misspelled the word "Byer's" as "Buyers". Thus, Byer's Choice retained the registration of the domain name, and Network Solutions was ordered to reactivate the website for BUYERSCHOICE.COM.

A copy of all the rules of the ICANN Domain Name Dispute Procedure can be obtained from ICANN's website at WWW.ICANN.ORG. It is important to note, however, that this is only one avenue that can be used to protect your rights. For example, in appropriate situations, litigating in federal court may be the preferred choice.

Ratner & Prestia specializes in patent, trademark, and copyright matters and realizes an obligation to keep its clients, and others, informed in those areas. The articles in this newsletter are intended to provide only a brief, general overview of each subject and are not necessarily the opinion of this firm. R & P recommends that readers seek specific information on particular matters of concern.

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