

Are you giving IP its due?

Intellectual property (IP) is becoming even more of a critical factor in the success or failure of M&A transactions. IP can easily derail a deal if these assets aren't accurately valued and the seller can't prove that it owns them.

Underlining the importance of IP

In many industries, a company's IP — including its trademarks, copyrights and patents — is at the heart of its value. Today's buyers are just as likely to acquire a company for its product lines and brands as its hard assets. But if a seller fails to properly research and vet its IP assets for potential problems, such as rival copyright claims or licensing restrictions, a prospective buyer could ask to renegotiate the purchase price or even terminate the deal.

Buyers, too, need to be on their toes when it comes to IP. The annals of M&A are filled with companies that failed to perform thorough due diligence on their target's IP holdings and later regretted it. Anheuser-Busch, for example, bought Sea World in the late 1980s without realizing the name rights to its biggest attraction, the killer whale "Shamu," were owned by another licensing company. Busch eventually had to pay that licensor.

The importance of IP to overall value varies by company, but any seller with patents, trademarks and proprietary technology is at risk for IP-related complications. Even if you use open source software — which many businesses may not consider to be relevant to a prospective merger — your right to your own technology may be challenged (see sidebar).

Sellers: Know what you own

One of the first things sellers should do when planning to put their business on the market is itemize IP holdings, possibly with the assistance of valuation experts and legal advisors. Note which IP assets are the most important to profitability. If possible, provide a thumbnail sketch of their application and range — for example, whether your trademarks are valid in every state.

Consider naming an employee Chief Intellectual Property Officer (CIPO) to manage the IP component of your transaction. This can reduce the confusion that occurs when different people are responsible for such items as litigation risk, patent management and licensing.

The CIPO will be responsible for analyzing and managing IP assets and tracking any liabilities, so he or she should have IP and legal expertise. An IP counsel generally is the preferred candidate for this position, but smaller companies may need to appoint two individuals as joint CIPO.

Buyers: Be diligent

Prospective buyers should begin their IP due diligence as early in the transaction as possible. The value of these assets is likely to factor significantly into your offering price. A professional valuator will assess IP assets' value by:

- Performing cost analyses to determine the amount of resources needed to develop and replicate them,
- Comparing them with those owned by competitors, and
- Calculating cash flows — including royalties and production cost reductions (if, for example, the IP is used to improve applications) — generated by them.

As a buyer, you also should:

Know your rights. Research all IP assets to ensure your target actually owns them. Don't assume that just because the seller has never been legally challenged you won't either. Sometimes competitors don't act until they feel threatened. And when a larger company buys a smaller one, it can make the trademark in question more valuable.

Seek exclusivity. The fluid nature of IP means the seller doesn't necessarily have exclusive ownership of a trademark or copyright. The seller may have only registered the trademark for specific products. International trademark rights also are a minefield. If the target didn't register its trademark in each country for specific products, a native company also may have rights to it.

Know when there are too many. If several other companies have any licensed use of a trademark copyright, it generally weakens the seller's claim to exclusive rights. Further, if the seller has been aware of trademark violations but didn't pursue the offenders, it may be difficult for you to pursue them once you assume ownership.

Keep in mind that, even if a seller notifies you of a potential IP challenge, your deal may still be viable. If you know your risks, you may be able to negotiate a deal with the rights holder before the issue becomes contentious.

Keep on your toes

Selling companies must recognize the value of their IP and thoroughly catalogue and appraise it if they're going to realize a fair price. Buyers should request proof of ownership for every IP asset. If you later become embroiled in an IP rights dispute, your acquisition could lose some — even all — of its value.

Sidebar: Is “open source” an open wound?

Many owners consider the use of “open source” software (OSS) the sole province of their IT department. Unfortunately, your OSS could cause problems if you plan to sell your company.

OSS is any type of software whose source code can be altered by its users and then redistributed in a modified format. Companies use OSS because there's no up-front cost to acquire the code. Yet it remains unclear how much exclusive intellectual property rights companies can claim to software that uses OSS components. A business preparing for sale

could discover that it has no right to prevent others from using or distributing its own code, simply because that code was developed initially via OSS.

Even with little clarity or legal precedent as to how OSS ownership should be managed, many open-source licenses exist that could, in theory, be applied to allegedly “open” codes. Cases where companies claim OSS license violations and patent infringements — often against businesses that didn’t even know they had exposure — are on the rise.