

# Open Book

A recurring feature  
by John T. Ramsay, Q.C.

*A review of current publications relating to the field of Intellectual Property licensing, transfer and tools therein.*



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## INTELLECTUAL PROPERTY ASSETS IN MERGERS AND ACQUISITIONS

Lanning Bryer and Melvin Simensky  
John Wiley & Sons, Inc.  
2002, ISBN 0-471-41437-9

Although this book is two years old, it is still valuable; indeed with the rise in merger and acquisition activity, it may be more valuable now than when published. This book is a compendium of sixteen separate chapters, each written independently of the other. Thus it has all the defects of a compendium—repeated basics building and repetition of themes that take the space of more in depth review. However, it also has the benefits of sixteen different contributions (some written by multiple authors)—differing perspectives, emphases and examples. So bear with the negative and access the valuable resources offered here.

This book will appeal to those doing legal due diligence, whether lawyers or those assisting in the legal due diligence process. Although it has some material for the business person, most business people will find it a bit superficial. The lawyer in me loved the legal resources and the abundance of checklists (a virtual legal toolbox); the businessman in me wanted more depth on the merger and acquisition's "winner's curse" and on valuation. All the business authors are well respected practitioners, but they were not unleashed into the same detail as the lawyers were. Next time, consider two volumes, one for the business person and one for the lawyer.

Chapter 1 sets the stage: "Mergers and Acquisitions: An Overview" by Patrick A. Gaughan. The reader may be somewhat surprised by a book that is really designed to assist the due diligence practitioner (usually someone who makes money—usually lots of it—from doing mergers and acquisition work) setting out as its basic philosophy the statements that most mergers and acquisitions fail. A look at this gloomy summary at pp. 1.9 to 1.10:

1. Target shareholders earn positive returns from merger agreements.
2. Target shareholders may earn even higher significant positive returns from tender offers.

3. Target bondholders and preferred stockholders gain from takeovers.

4. Acquiring firm shareholders tend to earn zero or negative returns from mergers.

5. Acquiring firm shareholders tend to gain little or no returns from tender offers.

R.B. Lamb picks up this theme somewhat in Chapter 2, "The Role of Intellectual Property and Intangible Assets in Mergers and Acquisitions," where he talks about "The Winner's Curse" at p. 2.5:

*The bidding wars in many M&A battles are so intense that frequently what is known in M&A financial theory as The Winner's Curse occurs. In short, whichever buyer wins an M&A auction has usually paid too much for the target firm and will probably not be able to achieve even its minimum hurdle rate of return on its investment. The combined entity will not achieve the necessary synergies to be more profitable than the individual companies prior to the merger. According to experts, taking various metrics into consideration, over the last 50 years up to 80 percent of all mergers and acquisitions have failed to achieve their required rates of return. While there are many causes of merger failures, the most common cause of failure is the payment of excess premiums over the stock market price of the target company. Although the winner's curse phenomenon occurs in many M&A situations, it is most frequently a problem in auctions for new economy companies whose key resources are their intangible assets and intellectual properties. This is a result of the difficulty in accurately valuing these assets. Companies whose unique strengths and financial growth potential are their knowledge assets, social capital, IP, and intangible assets are often overvalued. This was particularly apparent during the technological bull market of the 1990s.*

Lamb picks up this theme again at p. 2.26 where he writes:

*The former head of Lehman Brothers, Warren Hellman, stated:*

*So many mergers fail to deliver what they promise that there should be a presumption of failure. The burden of proof should be on showing that anything really good is likely to come out of one.*

*The latest tidal wave of merger activity is doing exactly what past tidal waves have done—hide the cold, hard reality that most mergers fail to achieve any real financial returns.*

The most common cited cause of M&A failure is the excessive control price premium paid by acquiring companies, which their future management efforts cannot earn back. Key reasons for paying excessive premiums center on their necessity to complete acquisitions, the synergies that the two combined companies can achieve together, the acquiring CEO's ego, and the Winner's curse in M&A auction bidding that inflates the bidding price beyond its reasonable payback limited.

A second cause of merger failure is that in 80 percent of all cases the managers failed to make post merger integration plans for successful integration of the two former companies into one. Integration failure is often a direct result of management's inability to execute the synergies assumed during the valuation process. Although often blamed for a lack of foresight after mergers fail, bankers argue that they base their synergistic forecasts on management's projections.

A third cause of merger failures is the lack of understanding of the acquired firm's IP and intangible assets or their practical uses, growth potential, or inherent limits. Inflated pricing of the acquired firm's IP and intangible assets is common. In depth M&A planning is often difficult, because valuable IP and knowledge assets are hard for acquiring firms to grow, enhance, or retain.

Lamb then goes through valuation techniques that will serve as a good introduction to the M&A technician but not the M&A designer—the latter will want more details such as offered by Razgaitis' *Valuation and Pricing of Technology-Based Intellectual Property and Dealmaking Using Real Options and Monte Carlo Analysis*. I do like Lamb's comments on the difficulty of using discounted cash flow for merging technology companies at p. 2.18:

Damodaran criticizes those who argue for new financial methods or new metrics to evaluate new technology firms and new business models.

This search for new paradigms is misguided. The problem with technology firms, in general, and new technology firms, in particular, is not that they lose money, have no history or have substantial intangible assets. It is that they make their initial public offerings far earlier in their life cycles than firms have in the past, and often have to be valued before they have an established market for their product. In fact, in some cases, the firms being valued have an interesting idea that could be commercial but has not been tested yet. The problem, however, is not a conceptual problem but one of estimation. The value of a firm is still the present value of the expected cash flows from its assets, but those cash flows are likely to be much more difficult to estimate.

Chapter 3 is by Gordon Smith: "Intangible Assets and Intellectual Property Accompanying Mergers and Acquisitions." It is an excellent primer on intellectual property. This will be valuable to the legal due diligence team who are not IP lawyers—often junior commercial lawyers brought in for the very time sensitive but grueling audits. Priming them in advance with this chapter would help them understand what they are to look for—when combined with the due diligence checklists that follow in this book will improve the quality of the work delivered and decrease the frustration of these juniors.

We get back to valuation in Chapter 4 by Michael Lasinski. If Lamb and Lasinski's contributions had been combined, this would have produced a much better book. Each has a lot to teach us, but the works overlap unnecessarily. Lasinski offers, at the end of his chapter, a table of royalty rate categories which is most interesting (although he suggests it may be somewhat dated). The valuation parts of this book can be supplemented by the increased number of valuation articles that appeared in *les Nouvelles* over the recent past.

In Chapter 5, Andrew W. Carter offers "Accounting for Intellectual Property During Mergers and Acquisitions." This may be the most dated portion of the book and will be of interest mostly to the business person. I felt I needed more guidance than was offered here—tell me more about the accounting rules and their impact on the design of the transaction.

Chapter 6 is the chapter that drew me to this book originally. In it, Glenn A. Gundersen writes "Intellectual Property Aspects of Acquisitions." I quoted extensively from a previous version of his material in my article "Dreadful Drafting, Dos and Don'ts of Warranty Clauses" published June 2003 in *les Nouvelles* (what else can an author do when he finds someone expressing his ideas far better than he can?). For the buyers, Gundersen offer this checklist at pp. 6.7 and 6.8:

The buyer's checklist will typically include the following questions:

- What intellectual property is necessary to operate the business? Does the seller own all the intellectual property necessary to operate the business? If so, does the seller own it free of any liens, security interests, and other encumbrances?
- If the seller does not own all the intellectual property necessary to operate the business, does it have sufficient licenses from third parties?
- With respect to intellectual property that the seller owns, is the seller in a position to transfer to the buyer all of the intellectual used in the business, or does the seller need to retain some of it for use in the seller's other businesses? With respect to intellectual property that the seller licenses from third parties, can the seller freely assign those licenses to the buyer, or must consents be obtained?
- Has the seller granted licenses of any of the intellectual property to third parties? If so, what are the terms of those licenses? Do they contain exclusivity provisions or other terms that would restrict the buyer's ability to use the intellectual property?
- Has the seller entered into settlement agreements or consents, or is it bound by judgments or consent order restricting the use of its intellectual property?
- Would the buyer's use of the intellectual property infringe any third party? Have any infringement or dilution claims been made against the seller with respect to the intellectual property? Has the seller made any infringement or dilution claims against third parties? Is there ongoing litigation involving the intellectual property? Are there interferences, oppositions, or similar proceedings pending in patent and

trademark offices at home or abroad?

- *Have any pending applications for patents, trademarks, or copyrights been rejected or refused registration?*

For representations to protect the seller, he offers this checklist at p. 6.13:

*For a variety of reasons, the seller will often want to modify or qualify the representations that the buyer proposes, including the following:*

- *Intellectual property law has become an increasingly contentious field. For large companies in particular, it will be rare that a seller has nothing to disclose in terms of claims, disputes, licenses, consents, judgements, or settlements.*

- *Intellectual property is often subject to liens, and the seller typically discloses that such encumbrances exist, linked with the condition that the debt will be satisfied at closing and the lender will release the lien.*

- *The buyer's proposed language may be so sweeping that it does not accommodate the quirks and inconsistencies in intellectual property law.*

- *The seller may not wish to become the buyer's guarantor as to the soundness of the intellectual property portfolio and may resist making certain representations on that principle.*

For the allocation of risk of infringement he offers this at p. 6.14 – 6.15:

*In order to infringe upon another party's copyrights or trade secrets, a company must first have access to those copyrighted works or secret information. This is not so with patents and trademarks. A company could infringe upon a third party's trademarks or patents without even being aware that such rights exist. Most companies do conduct searches of prior third party rights as part of the process of securing a patent. However, such searches have significant blind spots at the time they are conducted and can rapidly become obsolete, making it impossible to know for certain whether a patent or trade mark infringement claim is lurking. Even with copyright and trade secret claims, a company cannot be certain whether an employee has engaged in copyright or trade secret infringement without management's knowledge.*

*Finally, a determination of infringement inevitably involves subject determinations. Thus, a seller is asked to represent that its intellectual property does not infringe is, in effect, issuing a guarantee to the buyer. The seller instead seeks to represent that it has not received any claims or that it is not aware of the basis for any claims.*

This chapter is a must for the drafter of representations and warranties in the merger and acquisition agreement.

In Chapter 7, Thomas G. Jackson offers "U.S. Antitrust and Intellectual Property in Mergers and Acquisitions." This chapter provides interesting antitrust examples but otherwise was too short and at too high a level to fit in with the rest of the legal material.

In Chapter 8, Sheldon Burshtein provides "Intellectual Property and Technology Due Diligence in Business Transactions." This is loaded with detailed checklists for due diligence. Burshtein, like the reviewer, is Canadian

but has adapted his material so it will be of value for a U.S. reader. Burshtein has been a frequent speaker on due diligence, but this time takes his material to a new level of excellence. Frequently the due diligence is assigned to junior personnel, often lawyers, who have little idea of what is expected of them. If they took the time to read this chapter before commencing their task, their due diligence would be more productive for the client. Burshtein walks us through needs for due diligence (pp. 8.1 to 8.8), then provides guidance for establishing the scope and the cost of due diligence (pp. 8.8 to 8.16), provides a detailed review of what to look for with material broken down to the individual intellectual property rights (pp. 8.16 to 8.40), provides the analysis for contract reviews (pp. 8.47 to 8.48), gets more focused in the section on information technology issues (pp. 8.47 to 8.52), gives a brief review of liability issues (pp. 8.52 to 8.54), then industry specific issues and regulatory issues, closing out with comments on what to do with all the information you gathered in the process (i.e., interpretation and drafting the representations and warranties). Sixty-five pages of solid guidance! An example of Burshtein's assistance to the due diligence personnel is a checklist on contract review at pp. 8.41 to 8.42:

- *Review relevant contracts to identify intellectual property and technology.*

- *Obtain copies of all contracts that involve intellectual property and technology.*

- *Concentrate on the business relationships that are built around intellectual property and technology.*

- *Identify all schedules, appendices, and side letters to contracts relating to intellectual property and technology.*

- *Review all relevant agreements to determine whether they contain a restrictive assignment provision preventing transfer to the purchaser in an asset deal.*

- *Review all relevant agreements to determine whether they will be materially affected by a share deal.*

- *If there are restrictive covenants or consent is required, request appropriate waivers.*

- *Consider how diffuse the target's technology and intellectual property has become.*

- *Evaluate all license grants into the target to determine how reliant the target is on licensed intellectual property and technology.*

- *Evaluate all the grants out of the target to determine whether the business of the target will have the freedom to grow.*

- *Determine whether the target is a net developer or acquirer of technology.*

- *Determine the money flow to identify amounts to be paid out and received annually for the foreseeable future.*

- *Determine whether the agreements are in good standing, how long they run, what happens when they end, and whether or not they can be terminated earlier.*

- *Determine these questions from the perspective of problems in the context of the transaction as a whole.*

- Consider the agreements from the point of view of provisions providing for indemnification of intellectual property infringement.

In Chapter 9, Melvin Simensky (one of the editors of this book) and William Heberer offer “Intellectual Property, Due Diligence, and Security Interest Issues in Mergers and Acquisitions.” The strength of this chapter is in its discussions on security interests and recording of transfers, and the 196 resources cited in the end notes.

David A. Loewenstein writes Chapter 10, “Patent Opinions,” where he first builds the framework for the opinions and then gives us guidance as to what a competent or “thorough” opinion obtained to avoid willful infringement should contain. In summary, he offers this:

1. *The timing of an opinion is a significant factor in assessing the opinion’s competence. An opinion should be prepared prior to commencing any potential infringing activity, preferably before significant funds have been invested into the development of the product and prior to obtaining substantial venture financing. The underlying reason is to avoid the inference that the opinion was for ulterior reasons (e.g., to obtain venture capital financing and provide protection from enhanced damages), rather than to determine if a proposed product infringed a patent. This means the opinion must be relied on, and not be pro forma window dressing. Ordinarily, the opinion should be received and analyzed before a go ahead decision is finalized.*

2. *An independent patent attorney should be selected to draft the opinion. Cases suggest the opinion is considered more objective if drafted by outside counsel. Competent opinions drafted by in-house lawyers, however, are preferable to conclusory opinions drafted by outside lawyers. Cellpro intimates that an opinion drafted by a former partner of in-house counsel will be viewed less favourably. To the extent an opinion about the validity of one’s own patent is at issue, it might be preferable to obtain an opinion from a lawyer who did not draft the patent.*

3. *Written opinions fare better in litigation than do oral opinions. A written record is simply a more reliable record of what the infringer was told, and when.*

4. *The opinion should contain a well-researched, legal, and factual underpinning, including current legal principles—particularly burdens of proof related to invalidity and unenforceability—and sufficient factual foundation, including review of the file history and prior art, to support the legal conclusions. For infringement opinions, the opinion should individually address each claim of the patent at issue and should also consider the doctrine of equivalents.*

5. *The author should, where possible, verify facts supplied by the client and, if feasible, conduct his or her own factual research.*

6. *The opinion should avoid unsupported conclusory statements.*

7. *A new opinion should be drafted when there has been a relevant change in the accused product or method.*

He then offers reasons not to get opinions and concludes with comments on the disqualification of an author of an opinion from acting as trial counsel. A very well written and helpful chapter.

Chapter 11 is written by a team from Leger Robic Richard, headed by LES (USA & Canada) trustee, Francois Painchaud, based in Montreal, entitled “International Mergers and Acquisitions: The Canadian Perspective.” From a selfish Canadian point of view, this chapter is a jewel. We Canadians so rarely get material of the quality provided here, particularly with the development of Quebec related issues. This work is more of a background or “awareness-increasing” nature than the detailed checklist offered by Burshtein.

Chapter 12 rounds out the international review with “International Mergers and Acquisitions: The European Perspective” by Benedict Bird, Anna Carboni and Deborah Lincoln. Wherever based, you will want to read the section on warranties and indemnities at pages 12.16 to 12.19, which nicely complements Gundersen’s chapter, as well as the sample IPR warranties in Appendix I at pages 12.45 through 12.47. The 137 footnotes indicate the depth of this chapter.

The early stage practitioner might want to read Painchaud’s Chapter 11 and/or Smith’s Chapter 3 and then go to Burshtein’s Chapter 8. The drafter of the M & A document will use the information collected and go to Gundersen’s chapter for the drafting of representations and warranties.

Now we move to IP holding companies with Chapter 13, “Intellectual Property Transfers – Holding Companies” by Susan Barbieri Montgomery and Leonard Schneidman. Although often an IP holding company is driven by tax reasons, which are peculiar to the jurisdiction, there are good business reasons for using IP holding companies. They write at page 13.1:

*Centralized ownership of intellectual property assets, however, offers many business advantages, which include centralized strategic planning; a single team handling legal, marketing, and administrative matters; uniform policies and enforcement; and administrative and maintenance cost efficiencies. The business interests often favour a decision to centralize ownership in an intellectual property holding company.*

Having said that, the balance of the chapter focuses on U.S. tax reasons for IP holding companies.

Chapter 14 builds on the tax focus by discussing “Offshore Corporations” written by Tira Greene and Michael J. Ward. They offer this advice at page 14.8:

*In conclusion, the preference should be for properly planned, individually tailored structures instead of standard, off-the-peg products. This point cannot be overemphasized. Going offshore should not be treated as a cheap and easy panacea to fiscal structuring. Rather, it should be viewed as an integral part of an international business and, as such, financed and operated in the same way as the more mainstream domestic businesses. Having said that the rise of the Internet and other advanced communications systems means that data-based businesses and, thus, intellectual property-based businesses can be operated through a multinational structure far more efficiently than has previously been the case. A group not considering placement of intellectual property offshore, whether from start-up or as part of a merger and acquisition process, is giving up*

*potentially massive competitive advantages to rivals who have properly considered their options in this regard.*

Chapters 13 and 14, like the chapter on U.S. Antitrust, are somewhat surprising. Both are a bit superficial and are in contrast to the more in-depth material offered by Gundersen, Burshtein and Painchaud.

Chapter 15 focuses on famous marks. Theodore C. Max writes “Acquisition and Licensing of Famous Name Trademarks and Rights of Publicity in the United States.” After a well referenced overview of the U.S. law, it offers a valuable four page checklist of what should be included in an assignment or license of famous marks.

The text finishes up with Chapter 16: “Transfer of Intellectual Property Upon Merger or Acquisition” by Lanning G. Bryer (one of the editors) and Scott J. Lebson. This chapter offers comments on the methods of effecting transfers of intellectual property. The first part of the chapter is dated since it precedes the burst of the technology bubble, but the latter part is more timeless

in its insistence on recording transfers and analysis as how to effect registration.

Overall, I like this book—a very useful guide to M & A work. I was initially attracted to it when I was researching representations and warranties for my article and came across a predecessor of Glen Gundersen’s chapter, which I found to be outstanding. To my delight, I found so much other valuable material here. For me, its strength is as a legal resource, but that may be partly as a result of my recent review of Razgaitis’s two evaluation texts, *Valuation and Pricing of Technology-Based Intellectual Property*; and *Dealmaking Using Real Options and Monte Carlo Analysis*; and Al-Ali’s *Comprehensive Intellectual Capital Management* which offered such in-depth business related material.

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*John Ramsay is a Partner in Gowlings Calgary Office and is the author of “Ramsay on Technology Transfers and Licensing.”*