Putting the Diligence in Intellectual Property Due Diligence: Cautionary Tales of Those Who Didn't

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I. Introduction

Dockets throughout the country are replete with cautionary tales demonstrating the consequences of failing to perform sufficient intellectual property due diligence prior to deal consummation. As technology has developed exponentially in recent decades, the driving force behind many stock and asset transactions has become the target entity's intellectual property portfolio, which may consist of patents, copyrights, trademarks, trade secrets, and domain names. As such, the importance of conducting IP-specific due diligence has risen dramatically. Prudent buyers now must conduct the same level of due diligence to verify the ownership, condition, and status of intangible assets as previously was done with respect to tangible assets. Yet frequently, despite the enormous value of these IP assets, businesses continue to assume that IP rights will automatically transfer with the purchased assets or that general representations and warranties will protect them from IP issues that may arise down the road. However, as the cases discussed below illustrate, such assumptions and the failure to put the *diligence* in the IP due diligence process can have embarrassing and commercially disastrous consequences.

Before discussing the consequences, readers should understand that IP due diligence is the process of conducting an internal IP audit to help the acquiring entity identify and evaluate a target company's intangible assets and any associated risks. In the merger and acquisition context, the primary goal of the IP due diligence process is to ascertain whether the seller is capable of transferring the rights the purchaser desires and whether the transfer of such rights will allow the purchaser to meet its strategic goals without taking on unnecessary risks.

Although this article will not go into detail about the IP due diligence process, a few key points should be noted. First, regardless of the specific form of IP involved, the purchaser should obtain and study a schedule of all U.S. and international rights, including registrations and pending applications, that are owned by, licensed to, licensed by, or otherwise used by the seller. It is important to investigate whether these rights have been properly maintained, are currently in force, and could be effectively asserted if necessary. All agreements, licenses, and assignments relating to IP should be reviewed to determine their validity and scope. Another major IP due diligence component is to investigate any existing or threatened infringement claims brought by or against the seller and to analyze the potential risk of future conflict or infringement following the deal's consummation. In addition, the purchaser will want to identify any and all liens against, security interests in, or other encumbrances on any of the IP assets included in the transaction. Taking these due diligence obligations seriously from the beginning will help the purchaser avoid the many pitfalls waiting to ensnare the unwary.

II. The Consequences of Failing to Conduct Due Diligence

A. Trademark Acquisitions

At a minimum, a purchaser must ensure that all of the IP assets it desires or believes it is buying are actually included in the deal. The most famous and oft-cited example of a failure to perform proper IP due diligence in the trademark context occurred in 1998, when Volkswagen Group (VW) attempted to buy Rolls-Royce from Vickers PLC. Volkswagen outbid BMW, paying $712.7 million for the luxury automaker. Only after the deal closed, however, did VW discover that the Rolls-Royce trademarks, such as the name and famous flying lady logo, were not included in the sale. While VW received the rights to the factory, design, and equipment, it turned out that the extremely valuable Rolls-Royce trademarks were owned by Rolls-Royce PLC, the aircraft-engine manufacturer, not Rolls-Royce, Ltd., the auto company that VW had purchased. The aircraft company, which had close ties to BMW as a result of prior joint ventures, turned around and licensed the trademarks to BMW for $65 million. An embarrassed VW was forced to negotiate with BMW for assets it thought it had already bought, eventually reaching an agreement under which BMW licensed the trademarks to Volkswagen from 1998 to 2002. Thereafter, BMW took control of the Rolls-Royce name, and VW was forced to continue selling cars under the "Bentley" name only.[1]

Beyond guaranteeing that a target actually owns the IP assets, thorough due diligence requires further investigation to determine whether prior agreements might potentially limit the IP rights bought by the purchaser, i.e., to ensure that the rights acquired will actually allow the purchaser to use the purchased assets. Another trademark-related failure to conduct proper due diligence occurred in 1990, when the Clorox Company purchased the "Pine-Sol" business and trademark, among other assets, from American Cyanamid for $465 million. Clorox planned to leverage the strength of the Pine-Sol mark into other cleaning products that it produced. However, it turned out that Clorox purchased the Pine-Sol brand subject to a prior 1987 agreement between American Cyanamid and Sterling Winthrop, Inc., the owner of the "Lysol" brand. That prior agreement settled an earlier trademark dispute between the brands' owners and included de-

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tailed provisions regulating the way Pine-Sol products could be advertised and packaged and restricted the types of Pine-Sol products that could be sold. While Clorox attempted to integrate and diversify its new asset, in 1992 Sterling Winthrop successfully obtained a preliminary injunction against a television commercial for one of Clorox's Pine-Sol products that allegedly violated the advertising restriction in the 1987 agreement. Clorox then filed its own lawsuit, attempting to void the terms of the prior settlement agreement on antitrust grounds, but was unsuccessful.[2]

B. Patent Acquisitions

Assignments can complicate transactions involving IP assets and must be analyzed in detail to determine the true nature and extent of the assignee's rights, especially when agreements include the right to sue for infringement without any other rights accompanying the transfer. A cautionary tale occurred in 2004 in the case of *National Licensing Association, LLC v. Inland Joseph Fruit Company*. The plaintiff in the case was a "collective enforcement"-type entity specifically created for the commercial nursery industry. NLA had obtained via a limited assignment the right to sue for infringement of various plant patents and related trademarks—but none of the other associated IP rights. NLA brought an infringement action against growers in the United States, but the court granted the defendant's motion to dismiss based on a lack of standing. The court held that without the additional transfer of any proprietary interests in the patents and trademarks, NLA was at most a bare licensee with no authorization to sue for infringement. Further reasoning that such infringement actions most often implicate the validity and scope of an IP registration, the court stated that only "the patentee, the registrant, or one with a proprietary interest in the property—one who bears the risk of invalidity or restriction"—can serve as a proper plaintiff in an infringement suit. As a collective enforcement entity, NLA's entire intended purpose for existing was thus in vain.[3]

A key issue in evaluating the value of patents that are subject to an acquisition is determining their validity and scope. In this regard, the potentially disastrous consequences of failing to conduct proper IP due diligence were on display in *Digeo, Inc. v. Audible, Inc.* In 2002, Digeo, a communication technology company, purchased a patent covering pocket e-readers "as is" at a bankruptcy estate sale. Having failed to investigate the validity of the patent before buying it, Digeo later brought action against Audible for alleged patent infringement. During discovery, however, Digeo learned that its patent actually lacked legal title due to fraudulent conduct on the part of the inventors during execution of the declarations and assignment paperwork. As the holder of an unenforceable, and therefore worthless, patent, Digeo was forced to file a voluntary motion to dismiss the complaint with prejudice.[4]

On the flip side, Therakos, Inc., a subsidiary of Johnson & Johnson, was able to avoid a similar fate by engaging in thorough IP due diligence. In 2002, Therakos entered into preliminary investment negotiations with Immunocept, LLC, the assignee of a patent for medical technology that sought financial partners to proceed with clinical trials and commercialization. During the course of due diligence, however, Johnson & Johnson's patent attorneys discovered that the patent had been amended during prosecution to include the limiting phrase "consisting of" in a way that would likely be fatal for any potential infringement claim. Having protected itself through a diligent and thorough IP review, Therakos terminated the investment discussions and was able to avoid the fate suffered by Digeo. Immunocept, meanwhile, was left to file a legal malpractice claim against the prosecuting attorneys, which was later dismissed as barred by the statute of limitations.[5]

C. Copyright Acquisitions

When copyrights are involved in a transaction, particularly transactions covering software and other knowledge assets, proper IP due diligence requires reviewing the copyrights in detail and clarifying the scope and adequacy of any license agreements. Failure to do so resulted in exposure to potential copyright infringement liability for one software company in the 2007 case *Netbula, LLC v. BindView Development Corporation, et al.* As part of its proposed acquisition of BindView, Symantec discovered that software in BindView's product was possibly owned by Netbula. BindView had previously acquired a third-party company that, prior to its acquisition, had purchased one user development license from Netbula. However, BindView could not locate a Netbula license agreement in its records. BindView then contacted Netbula seeking to purchase the necessary additional licenses, but the parties were unable to reach a deal.

Despite Symantec's knowledge of the situation, the company went ahead with the acquisition of BindView, leading Netbula to file copyright infringement and other claims against both Symantec and BindView. The U.S. District Court for the Northern District of California granted summary judgment in favor of the defendants on the copyright claim because none of the parties was able to produce the original license agreement. Consequently, the plaintiff could not carry its burden to prove that the merger constituted an impermissible sale, transfer, or assignment or that the defendants had acted outside the scope of the agreement.[6] Perhaps Symantec's due diligence enabled it to assess the risks and ultimately escape infringement liability. But this muddled case shows that proper records of all IP transactions must be maintained, and any evidence that they have not been should be cause for concern and spark further investigation during the due diligence phase. Such due diligence could avoid needless litigation costs, not to mention the time and effort to untangle the mess created by a failure to investigate.

D. Open Source Software Acquisitions

Open source software can raise unique challenges for companies that distribute software or products containing software. Open source software is generally accessible to all, but license agreements may control or condition its use, distribution, and modification. It is crucial in any transaction involving software for a purchaser to audit and study the seller's usage of open source software. Failure to track such usage, or to ensure compliance with applicable licensing terms, could potentially subject a company's proprietary software to source code publication requirements. Such an unintentional consequence obviously could be catastrophic to the value of a business based on the proprietary nature of its software code. There are entities, such as the Free Software Foundation and the Software Freedom Law Center, that vigorously try to enforce the licenses governing open source software. These entities have filed lawsuits when they have reason to believe that a product is using open source software without disclosing the corresponding open source software source code. Examples of companies that have faced such lawsuits include Best Buy, Samsung, Verizon, and Cisco Systems. These lawsuits typically have settled before a court has forced a source code disclosure. Nevertheless, this is still a costly process that can and should be avoided with proper due diligence that includes a detailed analysis of any licenses that govern any open source software acquired in a transaction.[7]

E. Trade Secrets Issues

Purchasers also have found themselves exposed to liability in the context of trade secrets they acquire without investigating fully and diligently. Such was the case in the Seventh Circuit decision in *Forest Laboratories, Inc. v. Pillsbury Co.* There, Forest Labs had confidentially communicated a trade secret for packing sweetener tablets (so as to extend their shelf life) to another company. The assets of that company were later acquired by Pillsbury. Following this acquisition, a former employee of the other company who was then employed by Pillsbury communicated the secret to other Pillsbury employees along with the knowledge that the Forest trade secret had been received in confidence. Despite awareness that the packaging process was subject to confidentiality restraints, Pillsbury began using the trade secret process for its own tablet sweetener products.

Since Pillsbury had actual knowledge of the trade secret status of the process, the Seventh Circuit held that Pillsbury would be liable unless it had previously paid value for Forest's trade secret in good faith at the time it made the acquisition. The court noted a lack of evidence showing that Pillsbury paid anything of value specifically for the trade secret and held Pillsbury liable for misappropriation. The evidence showed that Pillsbury's purchase of the company's assets involved only the purchase of its packaging facilities as part of the existing marketing structure, which included Forest as supplier, not any specific expertise with a view toward independently exploiting that know-how for its intrinsic value. Had Pillsbury simply investigated the existence and status of its trade secret obligations when it acquired the assets of the company, it likely could have avoided the large judgment levied against it.[8]

F. IP Valuation

IP assets are financial assets and, as such, due diligence should include a detailed review of a company's projections and business model with respect to IP. Courts have proved to be particularly reluctant to grant a remedy to a purchaser that conducts this type of due diligence but then ignores or fails to further investigate uncovered red flags.

In 2000, HA-LO Industries, a manufacturer of promotional products such as coffee mugs bearing company logos, purchased Starbelly.com, Inc., an e-commerce startup, for $240 million. HA-LO believed Starbelly.com would complement and modernize its traditional sales force and sales methods. During the course of due diligence, however, HA-LO learned that Starbelly had never made a sale, was running through venture capital at the rate of $3 million per month, and had provided revenue projections related to its technology that were speculative and unrealistic. Despite the warning signs, HA-LO moved forward and completed the acquisition, then filed for bankruptcy one year later.

HA-LO later sued the investment banker it had hired to issue a fairness opinion, charging gross negligence. The courts were unreceptive to the claim: the Seventh Circuit affirmed the district court's finding that the investment banker had not been grossly negligent. The court noted that the investment banker was contractually obligated to rely on the start-up's projections, even though HA-LO, as the buyer, had knowledge that the projections were unrealistic. The Seventh Circuit characterized the suit as "nothing but an attempt to find a deep pocket to reimburse investors for the costs of managers' blunders."[9]

III. Conclusion

In transactions where the primary motivation may not be the acquisition of IP assets, many purchasers tend to underestimate the importance of conducting a thorough IP due diligence review. Some purchasers have learned the hard way that unidentified or unresolved IP issues can seriously compromise their position or the attractiveness of the transaction. In order to avoid the above-described consequences and to stay out of future articles like this one, it is imperative for any business engaging in a transaction that includes IP to take its due diligence obligations seriously. And once the due diligence has been conducted and the knowledge acquired, it is equally imperative for the purchaser to take the process a step further—to use the knowledge gained to the purchaser's advantage and not ignore it. Leveraging one's IP due diligence results can minimize the purchaser's risk or allow it to negotiate more favorable terms. This may take the form of deal term adjustments, a reduced purchase price, or the ability to construct seller representations and warranties that will limit the buyer's potential liability or cover losses. The lesson is clear: whatever the size, structure, and IP involvement of a proposed transaction, the time and money invested up front in proper IP due diligence should be considered more than worthwhile to avoid becoming a punchline in the business and legal communities.

Endnotes

1. Tom Buerkle, *BMW Wrests Rolls-Royce Name Away From VW*, N.Y. Times (July 29, 1998), http://www.nytimes.com/1998/07/29/news/29iht-rolls.t.html; *See also* Alan Cowell, *BMW to Get Rolls-Royce After All by Acquiring the Name*, N.Y. Times (July 29, 1998), http://www.nytimes.com/1998/07/29/business/international-business-bmw-to-get-rolls-royce-after-all-by-acquiring-the-name.html.
2. *See Clorox Co. v. Sterling Winthrop, Inc.*, 117 F.3d 50 (2d Cir. 1997); *see also* Anthony Ramirez, *Clorox Buying Brands of Cyanamid Division*, N.Y. Times (June 21, 1990), http://www.nytimes.com/1990/06/21/business/company-news-clorox-buying-brands-of-cyanamid-division.html.
3. *See Nat'l Licensing Ass'n, LLC v. Inland Joseph Fruit Co.*, 361 F.Supp.2d 1244 (E.D. Wash. 2004).
4. *See Digeo, Inc. v. Audible, Inc.*, 505 F.3d 1362 (Fed. Cir. 2007).
5. *See Immunocept, LLC v. Fulbright & Jaworski, LLP*, 504 F.3d 1281 (Fed. Cir. 2007).
6. *See Netbula, LLC v. BindView Development Corp.*, 516 F.Supp.2d 1137 (N.D. Cal. 2007).
7. Ashlee Vance, *The Defenders of Free Software*, N.Y. Times (Sept. 25, 2010), http://www.nytimes.com/2010/09/26/business/26ping.html?_r=0.
8. *See Forest Laboratories, Inc. v. Pillsbury Co.*, 452 F.2d 621 (1971).
9. *See HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC*, 517 F.3d 454 (7th Cir. 2008).

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