2023 International Client Seminar

March 2-5, 2023

The IP Risks of Change, and How to Minimize Them

Luck Favors the Prepared

Scott D. Stimpson
SILLS CUMMIS & GROSS P.C.
New York, NY
sstimpson@sillscummis.com

Lois Duquette
MCNEES WALLACE & NURICK LLC
Harrisburg, PA
LDuquette@mcneeslaw.com

I. Patent Due Diligence Issues

Considering the purchase or substantial investment of a technology-based company? Patent due diligence will be important.

Patent due diligence can encompass a variety of reviews, but typically key purposes of patent due diligence before an investment in a technology-based company (the "target" company) are to check the patents and applications of the target company and to evaluate the risks of infringing third-party patents.

Assignment records should also be checked to ensure that the target company has ownership of its patents and applications. All rights from all named inventors must be traced to company ownership – in the United States, any inventor can assign his or her rights, so you don't want to leave open the option of a competitor buying the rights of an inventor.

The Target's Patent Portfolio

A review of the target's patent portfolio is an important aspect of IP due diligence. The review should help provide comfort on whether the target company has adequately protected its technology and the extent to which competitors might be able to encroach on the technology and thus risk future profits of the target.

There are three types of patents: utility, design, and plant. The most common type of patent is the utility patent, and it protects the functional features of the technology. Design patents protect the ornamental (non-functional) aspects of a useful article, and plant patents protect certain types of plants.

Utility patents are typically the primary focus on IP diligence, as they can prevent competitors for using the technology. The scope of protection of a utility patent is defined by the "claims" of the patent. These are the numbered paragraphs at the end of the patent, and they define the "metes and bounds" of the patent – what the patent protects (and does not protect). Narrow claims (with many specific requirements) might precisely describe the target's technology but are not particularly helpful. That is, the narrower the scope of protection, the easier it will be for would-be competitors to design around the patent and cut into the target company's projected revenue. The best claims will have a range of protection – some claims encompassing broad descriptions of the technology (so they can better prevent competitors from access) and other claims providing progressively narrower protection (generally speaking, narrower claims are more likely to avoid the prior art and survive validity challenges).

If the target company is already in foreign jurisdictions or there are plans for that possibility, then the review and analysis of the target company's patent portfolio should include review of their foreign filings. Not only should those filings be considered for their substance (the scope of their coverage), but it should be checked whether patents and applications have been filed in any countries of interest (foreign filings can be expensive, so sometimes key countries will be omitted).

Third-Party Patents

IP due diligence, particularly for technology-based target companies, should include a search and review of related third-party patents. That is, you do not want to invest large sums in a company only to have the company shut down due to infringement of a third-party patent.

This process can start by identifying competitors and potential competitors, inquiring with the target company personnel as to whether there have been any threats from third parties about patents, and commissioning a "prior art search" for patents and pending patent applications in the same general space. No search is fool proof for a variety of reasons. For one thing, the search criteria used might simply miss some relevant patents or applications. For another, searches for prior art typically (and with good reason) will search the broad concepts of the technology, leaving the possibility of intricate details being outside the scope of the search (for example, specific parts of a large, complex machine could be subject to patent protection, but often searching for patents or applications relating to specific components is not cost-effective). Another reason prior art searching is not perfect is because patent applications are not published until 18 months after filing. So, a competitor could have recently filed a patent application that, if issued, will directly cover the technology of the target, but that application is simply not available for any prior art search to find until it publishes.

Qualifications aside, prior art searching, when done by reputable and experienced searchers, provides a reasonable comfort that most patents or related pending applications will be found. Competent patent counsel should review the resulting patents and applications and report on any areas of concern. Beyond just the basic question of whether third-party patents could cover the target company technology, this analysis would do well to consider practical issues, too. For example, even if a certain patent is not considered to be an infringement risk, if that patent owner has brought other patent litigations in the past, it might deserve special attention.

The diligence should also inquire as to whether the target company has licensed any patents (or other IP) from third parties, and if so the terms of those agreements should be reviewed.

II. Trade Secret Due Diligence

Like patents, trade secret due diligence can focus on the target company trade secrets and the potential for problems involving third-party trade secrets.

If the technology of the target company is one where trade secrets could be important (typically things like formulae, confidential data, critical and secret internal operations, etc.), then the target trade secrets should be identified for consideration (e.g., could it be potentially reverse engineered?), and investigation should be done as to whether the company has adequately protected those secrets. Even if the relevant information has not been disclosed outside the company, that is not sufficient to protect trade secrets – adequate procedures must be in place.

Third-party issues should also be addressed. How did the target company develop the trade secret? Were any third parties involved? Has the target company hired any key personnel related to the technology from competitors, and, if so, what was done to assure those personnel did not improperly disclose trade secrets from their former employers?

III. Trademark Due Diligence

If you are considering buying or making a substantial investment in a company with an important brand or brands, then trademark due diligence will be critical.

Trademark due diligence typically checks the assignment records to confirm that the target company owns the trademark registrations and the prosecution and renewal filings to ensure that the trademark registrations have been appropriately maintained. A missed filing deadline can result in a loss of registered rights or abandonment of an application, so it is important to check that the claimed rights are valid. In addition, it is prudent to review the Company's key brands and confirm that there are registered trademark rights or pending applications and to evaluate the strength of key marks vis a vis third-party rights.

The Target's Trademark Portfolio

A review of the target's trademark portfolio should provide assurance that the target has adequately protected its brands for the goods and services on which the marks are used and in the countries in which the target does business or plans to do business in the next few years. In the United States, trademark rights are based on the "first-to-file" or the "first-to-use," whichever came first – if there are conflicting marks, the party with the earliest date of first use or application filing date will have priority over the later user/filer. Although rights can be acquired through use, federal registrations offer some key advantages, including nationwide rights. Use based rights are limited by the extent of their use, and in particular, may be limited to a geographic region. In most foreign jurisdictions, trademark rights are based on the filing date of the application. As a result, in foreign jurisdictions, it is particularly important to confirm that applications have been filed or registrations maintained for all trademarks. There are some exceptions to the first-to-file rule in foreign jurisdictions, particularly if a mark is well-known, but it is much less complicated to own registered rights outside the U.S.

The target should provide a list of all of its trademark applications and registrations. The registries should be checked to confirm that the ownership is in the target's name, that the appropriate assignment documents have been filed if there was a transfer of ownership, and that the applications and registrations are active and without missed deadlines. It is also prudent to conduct an independent search for marks owned by the target to cross–check the information provided by the target. In addition, due diligence should include a review of deadlines that will fall in the first twelve months after closing to ensure that they are not missed in the transition. Because there is typically a filing window that is 6 to 12 months long, it can be helpful to discuss with counsel which party will be responsible for maintaining marks with filing windows that are open during due diligence and close within a few months after the closing of the transaction.

The due diligence review also should include a review of all trademark clearance search reports prepared by the target or provided to the target in "clearing" the trademark for any pending applications and recent registrations. A trademark clearance search provides information regarding similar marks that were co-existing at the time the search was completed and should be reviewed for marks which may pose a risk to the target's successful registration of the mark or a risk of an objection to the use of the mark. If the target does not have recent reports, then some screening of prior applications and registrations should be done of those marks to assess the risk that the mark will be refused registration or that a third party will oppose the use or registration.

The due diligence review also should include a review for "disclaimers" in the registrations. A "disclaimer" means that the applicant agreed to disclaim rights in a particular word or portion of the mark, that they would not seek to claim rights in the disclaimed portion of the mark, and that they are only able to claim rights in the disclaimed portion of the mark to the extent the disclaimed portion of the mark is part of the mark as a whole.

If any trademark rights are licensed from third parties, then those licenses should be carefully reviewed. Key points to consider are: 1) Must the Licensor approve the assignment of the license? 2) What is the royalty rate? 3) Is there a Guaranteed Minimum Royalty? 4) Is the License exclusive? 5) How extensive are the Licensor's approval rights? 6) Who will own sub-brands and copyrights incorporating the licensed marks? 7) What is the territory of the license? 8) What goods and services are licensed? 9) Can the Licensee add goods and services to the License? 10) Who is responsible for prosecuting and maintaining trademarks? 11) Who is responsible for enforcing trademark rights? 12) On what grounds may the Licensor terminate the License? If Licensor's approval is needed to assign the License, that approval needs to be obtained prior to closing. Furthermore, even with the Licensor's approval of an assignment of the license, the presence of a license can severely hamstring the ability to develop and grow a brand and may significantly impact the value of the rights being purchased.

Third-Party Marks

An important part of due diligence is to understand the landscape of third-party marks with which the target's key marks are co-existing and whether that co-existence is peaceful (or not so peaceful).

One way to assess the landscape is to conduct a screening of the target's marks as though they were being cleared prior to use or registration. A comprehensive search will pretty quickly show if the target's marks are co-existing with other similar marks and therefore have a limited buffer zone of protection, or if they are relatively unique and solitary marks in which case the marks should be easier to protect from encroachment by third-party marks. The report also can reveal third-party marks infringing on the target's trademark rights, and consideration should be given to asking the target to resolve the infringement pre-acquisition or waiting until post-acquisition for the acquiror to address.

It also is important to review the target's trademark enforcement records. Enforcement records should include cease and desist letters and the responses to the cease and desist letters, as well as records of oppositions filed at the USPTO and court filings. These records will provide information as to the strength of the target's trademark rights and how vigorously the target has defended its rights. It may uncover marks that the target has not taken any action against, in which case it would be important to evaluate if it is possible to take action against the mark, or if the marks likely will have to co-exist post-acquisition.

Lastly, all infringement claims made against the target and all settlement agreements and co-existence agreements should be reviewed. It is important to understand the claims that have been made against the marks to understand the risk of infringement claims in the future. In addition, parties frequently resolve infringement disputes with a co-existence or settlement agreement in which one or both parties agree to limit how, where and/or on what goods they will use their marks. These agreements can contain significant limitations on the target's rights so it is important to be aware of any such agreements to avoid unpleasant surprises post-closing.

IV. Copyrights

The ability to search ownership of copyrights is more limited than the ability to search patent and trademark ownership. Most rights in copyrights are not registered because one can obtain copyrights without registration. Registration is only required if the owner wishes to enforce the copyright. As a result, it is important to obtain assurance in due diligence that appropriate agreements have been obtained with content creators.

In the United States, employers own the copyrights in creative works created by their employees in the scope of their job duties. It can be prudent in the course of an acquisition to request an agreement assigning all copyrights (together with all inventions as recommended above in the patent section) to avoid litigation over whether particular content was created in the scope of the employee's job duties.

Furthermore, it is important that all independent contractors have signed an agreement with the target assigning to the company the contractor's rights in creative works made for the company. A common misconception is that a "work-for-hire" agreement is sufficient. Because only certain types of works may qualify as a "work-for-hire," it is important to confirm that the agreements contain language assigning all rights.

V. NFTs (Non-fungible tokens)

A newer type of asset that has received a lot of attention and typically involve several IP issues are Non-fungible tokens, commonly referred to as NFTs. NFTs are computer code pointing to the location of a digital image for authentication that use blockchain technology to record ownership of digital media (such as JPEG images, .mp4 video files and .mp3 audio files) and evidence authenticity by acting as digital title for digital media. They consist of unique digital identification codes and metadata stored on blockchain. If you are buying a business that "mints" NFTs or which owns an NFT that is an important asset, then your due diligence should also concern appropriate ownership of the rights in the NFT.

Many NFTs are linked to an underlying asset that also is protected by intellectual property rights such as trademark or copyright. Due diligence should confirm that the use of the underlying asset in the NFT does not pose unacceptable risk of an infringement claim. In addition, due diligence should include a review of terms of the underlying license to ensure an understanding of the rights transferred with ownership of the NFT and if the rights are sufficient for the buyer's goals. For example, rights typically would include the right to transfer the NFT but not the right to make copies or transfer rights in the underlying asset.