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The Financial Impact of IP Issues in M&A

By Stephen Ball and Jonathan Winter

Buyers often fail to consider the financial impact of intellectual property rights in M&A deals. While IP value can be difficult to determine, a target company's financials may rely on IP. For example, a company's financial outlook may be due to patent protection that provides exclusivity and prevents competitors from entering certain markets. It also may be due to goodwill associated with trademark protection, allowing a brand to charge a profitable premium over the competition.

Failure to account for this IP may result in lost value after the deal closes. If patent rights are not properly transferred, the purchaser may no longer even be able to make or sell a certain product. If trademark rights are not properly transferred, the purchaser may lose market share and margins due to forced rebranding. While these seem like fundamental considerations, some of the largest and most public deals often fail to plan for these risks, resulting in significant financial impact.

The consequences of failing to properly assess IP risks have been well documented. For example, in 1998 the Volkswagen AG Corporation purchased the automobile assets of the bankrupt Rolls-Royce Motor Cars Limited for $790 million, with the value of the physical assets estimated at $250 million. Volkswagen was unaware that Rolls-Royce's trademark rights were subject to a nontransferrable license from Rolls-Royce Aircraft. Volkswagen purchased the plant, the machinery and the automobile designs from Rolls-Royce, but only learned after the deal that the purchased assets did not include the Rolls-Royce® trademark. So while Volkswagen was able to build the car, it could not brand it with the famous trademark. BMW then acquired the trademark rights for $65 million from the bankrupt Rolls-Royce Aircraft and forced Volkswagen to concede the brand, resulting in a huge windfall for BMW.

Another example involves the 1990 purchase by the Clorox Corporation of Pine-Sol Corporation's business and trade identity. Clorox learned after the deal closed that the Pine-Sol® trademark was subject to a preexisting agreement that restricted its use to disinfectants. Though Clorox was able to manufacture products branded with the Pine-Sol trademark, it was unable to expand the brand into other product areas, denying Clorox its strategic goal and greatly reducing its return on investment.

More recently, Apple Inc. agreed to acquire Beats Electronics for $3 billion. In doing so, Apple purchased an infringement suit by Bose Corporation, which owns a number of patents directed to noise-cancelling headphones. After the deal was announced, Bose filed infringement suits in district court as well as at the International Trade Commission seeking to ban imports of the Beats headphones into the U.S. While Apple is accustomed to dealing with infringement lawsuits and may be willing to stomach the bill for litigation, not everyone has the cash stockpile to defend an expensive patent infringement lawsuit.

Such examples make it evident that even the most sophisticated transactions do not always account for IP issues that could have been addressed early in deal negotiations.

One of the most basic tenets of any transaction is to assure that the underlying IP is successfully transferred. If the chain of title is unclear due to numerous transactions, the apparent owner may not even be able to transfer the IP to the buyer. The issue becomes more complicated when dealing with portfolios having numerous international patents and trademarks.

In order to limit risk, a number of issues should be considered at the forefront of each deal:

1. What IP does the target company own? Is the title properly recorded, and is chain of title clear?

2. Are there any deadlines or renewals required to maintain the IP? If so, which party will be responsible so that no rights are lost?

3. What are the top products of the target company? Are those products protected by IP?

4. What IP is owned by the target company's competitors? Are there current or potential infringement issues?

5. Are there preexisting agreements that restrict the buyer from realizing its strategic goals?

Considering these ultimately will improve the financials of the company and lead to a higher return on investment. If the risks are understood from the start, the deal can be priced to account for them. For example, if there is concern about a potential infringement lawsuit, the price of an IP insurance policy can be built into the deal. If rights are subject to preexisting restrictions, the deal can be made contingent upon the acquisition of the desired rights.

It is also important to account for post-deal considerations. The task of recording title can be complicated and is regularly put on the back burner. Although an M&A agreement may appear to transfer title from seller to buyer, many jurisdictions require affirmative recordation of assignments. Thus, without proper recordation a buyer may not actually own the IP. In addition, the seller may no longer exist once the deal closes, rendering it impossible for title to be perfected or at least significantly increasing costs. The costs for perfecting title can be estimated up-front and should be negotiated as part of the deal. In fact, savings of 50 percent or more can be obtained with proper planning.

There are a number of IP risks inherent in every deal. Considering these risks early in the process will help to avoid problems, or at least will allow the purchase price to account for them. Only with proper IP due diligence will a company fully understand these risks and their financial implications.

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