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INTELLECTUAL PROPERTY MANAGEMENT IN MERGER & ACQUISITION TRANSACTIONS

- Karan Sharda & Pushti Dublish¹

ABSTRACT

This article intends to study the role of intellectual property in the Merger and Acquisition transactions. The prime objective in studying its role is to find out how the intangible assets of the merging entities participate in the transactions related to the combination of two or more entities. Merger and Acquisition are very profitable but to reach the outcome there are several compliances and obligations to be performed, one of which is the intellectual property management of the merging entity or entities. This article discusses how intellectual property is the driving force for the merger transactions which further comes with its benefits and the central problems faced while fulfilling the requisites of the transfer of intangible assets. It further states the due diligence which forms the core of any corporate deals.

Keywords: Intangible assets, Due Diligence, Mergers, Driving Force, Intellectual Property

INTRODUCTION

With the inclusion of high standard technology, huge market control, extreme competition, corporate scandals, monopoly power has amplified the pressure on the companies to stand out with their efficient and effective working in today's competitive corporate world. The burden on the companies (especially the small businesses) either leads to their extinction or a hard-hitting survival. Merger & Acquisition (hereinafter referred to as M&A) participates and enables the companies around the world to work effectively under the pressure and reduce the risk of getting extinct. It also enables them to tackle the inevitable situations that occur in the corporate space. The foundation of the merger was witnessed in the late 1990s and an extreme augmentation in the corporate restructuring observed in the 21st century where mergers,

¹ Students of Galgotias School of Law, Galgotias University

acquisitions, and amalgamation has captured the economy. It turns out to be the driving force for stability as well as the potential ability of the organizations around the world.² Corporate Restructuring participates when the growth strategies of the corporation don't work in the competitive market. The uprising globalization has raised the intensity of the M&A in the given era.³

M&A, being a corporate growth mantra of the century, has also leveled up the creativity along with the productivity to a new-fangled pinnacle. It is a constructive strategy to gain excellence and expansion by joining together with a similar interest.⁴ It provides the swiftest way that facilitates in acquiring skills and competencies, enlarging customer base, funding, combating competition, and increasing profitability.⁵ Thus, it can be said that M&A plays a crucial role in two strands- Firstly, improvising the multinational companies and Secondly, providing a plan to the Micro, Small, and, Medium Enterprises to survive and earn the profit.

MERGER, ACQUISITION, AND AMALGAMATION

A merger is a fusion of one or more companies to form a new company that results in achieving economies of scale, access to market, increased profits, survival, etc. Its concept is defined in the Companies Act, 2013 as the combination of two or more entities into a single entity and thereby merging their assets and liabilities. In mergers, the merging entities cease their subsistence and work under a new entity viz. the anchor entity. Whereas Amalgamation is used interchangeably with the merger but it is different from a merger in a micro sense as it could take place like absorption. An acquisition can be termed as an act of acquiring control over the assets or the management of the other company without any fusion between the two.

INTELLECTUAL PROPERTY

When companies merge their core competencies, the intangible and tangible assets of the target company in terms of cash is transferred to the acquiring company in which the intellectual

² D.N.S. Kumar, “*Strategic Acquisition through Value-Based Management: A Case Analysis*”, Vol. XXIV, No. 4, Abhigyan, 42-47, 42 (2007).

³ Mrityunjay Athreya, “*Strategic Management of Mergers*”, Chartered Secretary, 1131-1132, 1131 (1997).

⁴ Rachna Jawa, *Mergers, Acquisitions and Corporate Restructuring in India: Procedure and Case Studies*, New Century Publications, New Delhi, 2009, p. 1.

⁵ Mandavi Singh, *Intellectual Property: The Dominant Force in Future Commercial Transactions Comprising Mergers and Acquisitions*, INJIPLaw 11, 180-193, 180 (2009).

property (hereinafter referred as IP) is found to be the most significant one.⁶ The IP law is very emerging in the corporate world and its emergence has affected the M&A consideration.

Primarily, what constitutes IP? This terminology is universally used and also known by the trademark, copyright, patent, trade secret, etc. This is evidence for the human creation and original work which is novel and created using his intellect. The corporate world has tried to capture these assets and harvest them- through mergers, helps to gain ownership over the assets, and through acquisition, they gain control over the assets. Therefore, the value of IP and the technology transfer have become the key determinants of business value. The deals based on the IP have become conventional and urbane; the willingness to divide and construe risk has been increased. But the companies along with the investors are signing these deals and find IP financing as a comfortable option.

INTELLECTUAL PROPERTY: A DRIVING FORCE IN M&A CONSIDERATIONS

It is pertinent to note that in the current period, every M&A deal of the companies involves the IP assets. Therefore, it is considered a valuable asset that every single company owns. This has alerted the companies to collect full-fledged information while taking any strategic decisions involving IP assets in the M&A consideration to steer clear of the potential audits, penalties, and even litigation in the future. As the IP comes under the non-physical assets, therefore laws have been made to protect them from any unauthorized use. Several acts like Patents Act 1970, The Copyright Act 1957, etc have been enacted which governs the various categories like transactions, IP holder rights, registration and also protects the infringement of the laws by providing remedies, damages, etc.

The fact cannot be ignored that every company holds these assets virtually like they create designs, use computer software, have their copyright, owns a trademark, invent new product line and mainly they use technology. They run their R&D cell. Hence, the point is to identify the company's or the target firm, the value of its assets, earnings, and the IP needs to be evaluated.

Technology-Driven M&A transactions provide a passage to the increasing innovations of the products and accelerate the speed of the various upgraded introductions in the business line,

⁶Nishti Desai, *Mergers & Acquisitions in India*, (Sept. 29, 2020, 12:47 AM) http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Mergers___Acquisitions_in_India.pdf.

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reduce the R&D costs, and helps in allocating funds in the areas of core competencies.⁷

The technology is divided into two categories based on the assistance. The Upstream Technology helps in diminishing the transactional cost whereas Downstream Technology assists in developing new products and services. But this technology knowledge transfer in M&A deals generate problems as to Know-how, Know-what, Know-who. It is because the transaction is concerned with IP rights, its transfer differs from the transfer of products as:

- Knowledge exchanged cannot be reversed.
- It is a difficult task to assemble the crucial parts of knowledge to develop future IPs.⁸

The merger also facilitates the companies in gaining access to the pools of IP assets which helps in reducing the litigation cost and complex procedure. For example, IBM acquired the Dash eServices in 2004, Daksh eServices being the third-largest Indian call centre and back-office service provider which has revenues of \$60 million for \$150 million. This has facilitated IBM not only in gaining the greater competency but also the Daksh's copyrighted software and the other related IP.⁹

Likewise, in 2008 when Microsoft acquired Yahoo in a hostile manner for USD 45 billion, it was more associated with acquiring IP assets rather than the human resources or tangible assets.¹⁰

IP VALUATION DILENMA IN M&A

The most peculiar issue related to the due diligence is to gauge the IP assets' value. It is easier to measure the value of the 3-D object like real estate. When the task is to value an abstract object like IP, the main difficulty arises. The question related to valuation has gained importance because the ratio of intangible assets to tangible has been multiplied in numbers and is more towards intangibles. Many renowned companies have a greater percentage of the value of intangibles such as Microsoft with 98.7%, Johnson & Johnson with 87.9%, Procter &

⁷ Mandavi Singh, Supra Note 5, at 182.

⁸ Shreya Bambhulkar, *Intellectual Property Issues in Mergers and Acquisitions*, ipleaders (Sept. 28 2020, 11:47 PM), <https://blog.ipleaders.in/ip-issues-in-ma/>.

⁹ *IBM to Acquire Daksh eServices*, The Hindu, <http://www.hindu.com/2004/04/08/stories/2004040804721800.html> , April 8, 2004.

¹⁰ H. Moore, *Market Reaction: Microsoft's Offer Looks Like a Knockout*, *The Wall Street Journal*, Feb. 1, 2008.

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Gamble with 88.5%. This proves that the intangible assets prevail in today's corporate world.¹¹

CORE PROBLEMS IN IP VALUATION

Firstly, Intangible assets do not comprise only the traditional IP assets but also includes the other capitals like distributed networks, R&D capabilities, trained workforce, manufacturing practices, and many more. Accordingly, the assets need to be differentiated and divided into the IP assets and the additional intangible capital heads. The IP provide their owners with the enforceable right to appropriate the benefits derived from such assets and but in case it is an individual IP asset, then it can be sold and acquired separately from the firm's entity. In contrast, the additional intangible capital does not enable its owners with an enforceable right and hence it cannot be separated from the company. It is contended that the additional intangible capital provides an advantage over the market rivalries, nevertheless in the case of M&A, the capital assessment is difficult.

Secondly, the existence of several valuation methods for IP assets constructs a huddle of difficulties. But there is a lack of consistent methodology which would translate a company's IP position into quantitative economic terms. The choice of method is the central problem and the evaluation of results using different methods and their comparison is still a question that needs to be answered.

Thirdly, some factors would directly influence the result. Even if an equation for the valuation is made, then the factors and variables concerned with it will complicate the ultimate result.

Variables affecting the valuation are:

1. Given Industry
2. Market share of the owner
3. Profits
4. The occurrence of new technologies
5. Concentration and level of competitiveness on the given market
6. Barriers to entry in the respective industry
7. Expansion prospects
8. Granted legal protection

¹¹ Smith, G.V. & Parr R. *Valuation of Intellectual Property and Intangible Assets*, Third Ed, John Wiley & Sons, New York 11, (2000) (hereinafter Smith and Parr).

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9. Remaining economic life ¹²

Inferring from the above factors that the valuation of IP assets needs to be done in a broader sense. These factors, if not considered, then misleading outcomes will be obtained resulting in deprivation of contact with reality.

Fourthly, in a practical view, this valuation involves costs such as the time and financial resources which should be kept in mind.

For example, in-depth valuation of every patent is required in the case of a small portfolio and aggregate valuation in the case of large patent portfolios as it is impossible to evaluate every patent leading to inefficiency and wastage of time.

Lastly, In contrast to financial and physical assets, the marketing area for IP assets is still emerging. Furthermore, the disclosure of information related to the details of comparable transactions is not yet made available to the public and remains confidential to the parties to the transaction as mentioned in their policy. Conversely, accessibility to such information does not make any major discrepancy in regards to the comparability of data. It is because all the contractual terms and conditions, subsuming the circumstances of the M&A deal are mostly transaction-specific and personalized as per the requirements of the related parties. Thus, the area for comparison persists. The inherent variations are what makes any intangible asset and IP viz. the core characteristic also a requisite for the law itself.¹³

It is pertinent to note that the variables affecting valuation are not exhaustive, more variables can be added which are also to be studied separately while evaluating the IP assets.

METHODS USED FOR IP VALUATION

These methods were prepared for the evaluation of tangible assets. Although there is a difference between tangible and intangible assets which then raise the question on the evaluated result, they are widely accepted. There are three methods developed for the valuation of tangible assets:

1. INCOME-BASED METHOD :

¹²Parr, R., *WIPO Joint Training Course for Asia and the Pacific Region on Intellectual Property and Technopreneurship Development, Module 6: IP Valuation Issues and Strategies*, 11, (1999) (hereinafter Parr)

¹³ *Id.*

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This method evaluates an asset based on the present value and how much income it is going to generate in the future.¹⁴

The four variables concerned are:

- Net income of the asset expected to generate in future.
- Tenure over which the income is expected.
- The present discounted rate for future income (a risk-free return along with adjustment of inflationary risk).
- The risk concerning the realization of income.¹⁵

2. COST-BASED METHOD

Under this method, The purchase price is determined by the cost to create or the cost to replace. This technique is trouble-free but it overlooks the changes in the time value of money and ignores the maintenance. Since this method takes into account the cost of building up the business from scratch, it is more appropriate in cases of build-operate-transfer (BOT) deals.¹⁶

3. MARKET-BASED METHOD

The market-based method is extensively accepted and employed in the case of tangible valuations. In this, the real value of an asset is calculated by comparing the equivalent transaction of unrelated parties in the market.¹⁷

The four essentials to classify the transaction as comparable:

- An active market for the asset valued
- Sufficient transactions for comparing the assets
- Accessibility to the price information of the compared assets
- Comparable asset transactions must be performed on arms' length¹⁸

IP DUE DILIGENCE

¹⁴ Smith and Parr, Supra Note 11, at 164.

¹⁵ Id, at 164-168.

¹⁶ Mandavi Singh, Supra Note 5, at 185.

¹⁷ Daniel, B. et al., *Financial Aspect of Licensing Agreements: Valuation and Auditing*, 644 PLI/Pat 85, 93, p. 94. (2001).

¹⁸ Smith and Parr, supra note 11, at 181.

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Donald M. DePamphilis said that “*No matter how bold, innovative, or precedent-setting a bad strategy is, it is still a bad strategy*”¹⁹

Due Diligence (hereinafter referred to as DD) plays a very central role in making successful M&A deals. It provides a disparity of information regarding the assets and other inclusions between the buyer and seller. It is somehow related to a ‘*What can go wrong*’ procedure. The lack of disparity in the DD procedure would result in creating asymmetries between the buyer and seller in the M&A transactions. Hence, the expectation of the buyer or seller doesn’t meet with that of the other or if the company withholds any relevant information from the other.

IP and Information Technology are the key determinants of the company’s value but still, it can be inferred that the modified methods for DD have not been practiced yet. Mostly, entrepreneurs depend more on traditional matters like suit papers, credit agreements, and accounting work papers.

DD is an investigative process that aims at revealing the relevant information related to business about the counterparty. The information collected from this procedure lays down the foundation of the deal and also assists in the deal-drafting process. A well-planned business strategy encompasses proper DD modus operandi, time-schedule, and the level of comprehensiveness²⁰. Poorly-structured or improper application of business strategy results in ultimate failure in the IP-driven M&A transactions and is the fundamental reason for such failure.

“*From a business perspective, the goal of performing due diligence is to determine whether a transaction makes business sense.*”²¹ While conducting DD, there are two approaches to be followed:

- **PROCEDURAL APPROACH:** It discovers the potential risks on the sellers’ side.
- **SUBSTANTIVE APPROACH:** It assesses the value from a business standpoint.

The simultaneous application of these two approaches, as stated-above, gives a 360° oriented view. They are correlated to each other and can be applied vis-a-viz. For example, the inconsistency revealed in the procedural approach may affect the value assessment in the

¹⁹ DePamphilis, D.M.: *Mergers, Acquisitions and Other Restructuring Activities*, 6th Edition, Elsevier, p. 136, (2012).

²⁰ Id.

²¹ Klein, D.M.: *Intellectual Property in Mergers and Acquisitions*, Thomson West, p. 140 (2007).

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substantial approach or the findings revealing the discrepancies would help in better procedural DD.

CENTRAL PROBLEMS RELATED TO DUE DILIGENCE

1. Does the main force of M&A strategy reside in obtaining IP assets?
2. Which entities employ the given techniques of IP, what is their position with the acquirer and whether the other participants in the market are interested in the given technology?
3. Whether the respective industry is prone to litigation?
4. Identification of the complexity of the IP policy of the target company?
5. Do the parties considers an asset-purchase or stock purchase?
6. Identification of important objectives of the transaction.
7. Consistency of the targeted IP assets with the pursued IP business strategy of the acquirer to find out.²²
8. Identification of the level of concentration on the given market?²³

Answering the above-mentioned questions, the main objective of the parties is confronted and their position of IP assets is mentioned in the deal. A hierarchy of transactions is to be made as the value is assessed on various pointers. IP is to be divided under 3 groups based on their relative importance in the deal.

First Group i.e. Crucial IP assets

Second Group i.e. Supplementary IP assets, and

Third Group i.e. Marginal IP assets

This division of IP assets assists in targeting important assets and also conducts an in-depth DD process. The first two groups target the two approaches (procedural and substantive) and in the third group, only the procedural approach is taken as it eliminates further risk related to marginal assets.

The IP due diligence outcomes determine an optimal structure and the nature of the deal. The answer to which purchase option is to be selected for the acquisition of assets is based on the

²² Bosch, M.C. and Burgy, A.L., *Demystifying IP Due Diligence, Managing Intellectual Property*, (Sept. 29, 2020), <http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=3af2e1b1-aa4f-47fa-bf5c6429a5171f55>.

²³ DePamphilis, *Supra* note 21, at 140.

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DD outcome, but it directly affects the terms of the contract like risk mechanisms, price adjustments, and representative. It is imperative to answer the question ‘how deep under-surface’ should the DD investigation conducted. Hypothetically, an in-depth study of the minor issues affecting the DD process should also be carried out but it would be very time-consuming as well as incurs a huge cost in paperwork, R&D, etc, and also slow down the process. Therefore, the importance of that issue is taken into consideration in case it will severely affect the deal, and non-observance of the issue results in misleading outcomes. While performing the DD process one has to bear in mind the objective of the deal. It shouldn’t be perceived as killing the deal or finding reasons to cancel the deal but to gather the relevant information fundamental for the deal.

Discovery of the major issues is expedient and they are mentioned in the executive summary whereas the other minor details and issues are mentioned in the DD report.

WHO PARTICIPATES IN IP DUE DILIGENCE

On the major part, “DD is the province of transactional lawyers and accountants, with secondary involvement from subject matter experts (“SMEs”), such as environmental consultants, employee benefits specialists, and the like. However, concerning IP and IT matters, this is not appropriate.”²⁴

In IP matters, the respective Subject Matter Experts participates in the process by selecting their related field.

Like,

Patents - Engineers, Scientists, and Patent Lawyers

Trademarks - Sales and Marketing Management, and Trademark counsel

Copyright - Designs or literary expertise, Engineers and Computer scientists

Trade Secret – Lawyers, Human Resource Professionals

INTELLECTUAL PROPERTY BENEFITS AFTER DEAL

²⁴ Martin B. Robins, *Intellectual Property and Information Technology Due Diligence in Mergers And Acquisitions: A More Substantive Approach Needed*, JLTP, 321-356, 326 (2008).

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Many companies have misconceptions and are afraid to leverage their IP portfolio in the fear of losing their reputation because of using aggressive IP tactics. But, a well-thought business strategy would help the companies to increase the value from its IP portfolio using the different combination of business models:

- IP sale – Selling IP to the highest value participant.
- Spin-off – Spinning off IP assets like a start-up in exchange of equity.
- Internal licensing program – Licensing patents to obtain a variety of currency denominations.
- IP subsidiary – Setting up a subsidiary for patent licensing.
- Traditional patent pool – Licensing of other essential tools as well along with the patents.
- Patent platform – Licensing patents through a flexible patent platform.
- Donation – Donating patents to attain definite strategic goals and expand tax advantages.²⁵

Licensing the core IP assets, is the most considerable tactic, by the companies to other firms to leverage as it will aid the company in increasing the cash as well as this strategy will also generate financial and strategic benefits.

CONCLUDING REMARKS

Intellectual Property, the most crucial assets of the company plays a vital role in M&A transaction. It fuels the company by following structured strategies to deal with the IP assets of the companies. Its valuation has not yet defined properly but some alternatives are present that would assist the company in the valuation and the estimation of the same. Every company incorporates intending to achieve growth in future. It is well said that the **BETTER IDEA IS ALWAYS SOMEONE ELSE** and believing in this, every company wants to acquire the target company's knowledge, their IP assets, and the technology. It is imperative to note that the Due diligence process should be done carefully so that no stones would left unturned. This process has a greater impact on the M&A deal. It can be inferred from the collection of data that Intellectual property is the dominant force in the M&A.

²⁵ Mandavi Singh, Supra note 5, at 188.

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