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PATENT & TRADEMARK PROTECTION

SALE OF A BUSINESS - THE FORGOTTEN INTELLECTUAL PROPERTY ASSETS

1. Due Diligence Is Critical

Most business owners are familiar with the general requirements for selling a business or major assets of a business. They spend most of their time and effort negotiating asset transfer agreements that detail the exact terms and conditions of the transfer. Certain types of intangible assets often receive less than their fair share of attention from the parties. Software licenses, trade secrets, copyrights, trade names, trademarks, service marks, and patents are often omitted from transfer agreements, but these assets can have a significant impact on the value of the business.

Thorough due diligence is crucial to ensuring proper treatment of intangible assets. The due diligence inquiry should focus on verifying the value of the purchased assets by assessing the value, risks, and liabilities associated with each asset. Correspondingly, the results of the due diligence inquiry should influence the structure of the transaction by informing the buyer of any assets that should be left out. Proper due diligence will provide the buyer with the information it needs to determine whether the deal should be structured as an asset purchase or possibly a merger with a divestiture of the unwanted assets. Further, the due diligence results should impact the content of the terms, affecting the price and the specific warranties for various assets.

2. General Principles

The due diligence process should be performed by independent counsel. The buyer should not rely on the seller's counsel to provide a complete listing, and certainly not an assessment, of the assets being transferred. Counsel should identify all types of assets and then catalogue each individual asset, determining the date of application, issuance or registration, expiration, and any maintenance or renewal fees. For example, the owner of a registered trademark must periodically submit proof of use. The due diligence process should determine whether the marks are still being used, if they are still registered, and what maintenance issues are outstanding. This is important if the buyer intends to continue to use the marks or to put them up as collateral.

The buyer should also verify proper recordation of title and review all existing assignments, documents recorded at the Canadian Intellectual Property Office (CIPO) agreements granting security interests, and financing statements to determine whether there are any outstanding mortgages or liens. All too often a company believes it has clear title to an asset, only to find out that its predecessor failed to obtain an assignment or failed to properly record title. This is particularly important with regard to copyrights and patents because ownership is presumed to vest in the author and inventor, respectively. In these cases, unless there is a clear written assignment, a buyer is unlikely to have title.

3. Licenses

During the course of a normal due diligence inquiry, counsel often briefly reviews existing licenses that have been taken and granted on copyrights, patents, and trademarks. However, licenses for more expensive, sometimes custom software relating the company's web site, accounting, billing, inventory, and production may be overlooked. Often, these licenses are non-transferrable or require a substantial fee to transfer the license. These transfer restrictions often apply even if the business is only changing corporate form, i.e. changing from a partnership to a corporation.

Failure to adequately transfer or update the licenses for these critical pieces of software can potentially have a significant impact on a company's bottom line. In the event of a copyright infringement suit, the owner of the software may assert an infringement claim and allege actual damages plus any profits that are attributable to the infringement. Alternatively, the copyright owner may ask for statutory damages of $30,000 per work infringed, or $150,000 if the infringement was wilful.

Rather than serving as a potential liability, the transfer of these assets may be used as an opportunity to renegotiate licenses to either make them transferable, to eliminate the transfer fees altogether, to alter the terms of any maintenance fee contracts, or to alter the scope of the licenses. Thus, any due diligence plan should include prioritization and review of all critical software licenses to ensure that the client is not inadvertently putting itself at risk.

In addition, counsel should also review all existing licensing agreements made with the seller's licensees to determine who else may use the assets. Any patents, trade secrets, or trademarks that have been licensed to a competitor of the buyer (such as when the seller is a supplier) can seriously diminish any competitive advantage. On the other hand, patent counsel should evaluate whether any patents licensed by the seller to third parties also cover processes or devices used by the buyer.

4. Trademarks and Service Marks

A trademark identifies its owner as the source of particular goods or services. To validly assign a trademark or service mark, the assignment must be in writing. The transfer documents must assign both the mark and the goodwill of the business represented by the mark. Assigning only the mark, apart from its associated good will, creates an assignment in gross and the mark ceases to exist. If the mark is ineffectively assigned, then no rights pass to the purported assignee. Typically, the assignor, believing that the mark has been transferred, stops using the mark, which then becomes abandoned due to non-use. Further, the purported assignee has no title and no standing to sue third parties for infringement. However, the agreement between the parties is binding, so the purported assignor cannot sue the purported assignee for trademark infringement.

With respect to licensing of trademarks and service marks, the good will associated with a mark imposes an additional requirement that is not present in most licenses. The license agreement must have minimum quality control provisions on the goods or services that allow the licensor to maintain the value of the good will. Typically, these quality control provisions give the licensor the ability to inspect the facilities and goods at least on an annual basis. Failure to provide adequate quality control provisions may result in the licensor being deemed to have abandoned the mark because it is no longer policing its use. Ineffective assignment or licensing of a trademark eventually results in abandonment of the mark and, possibly, trouble for the attorneys who were involved. These issues can easily be avoided by incorporating a review of

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all the marks being transferred into a comprehensive due diligence plan.

5. Trade Names

When dealing with trade names, it is important to maintain a clear distinction between a trademark, which symbolizes the good will in the goods or services, and the trade name, which symbolizes or identifies the reputation of the business as a whole. Further, under common law, assigning a corporate name necessarily also assigns any trade name rights in the name.

The corporate name is not necessarily the same as the trade name of the business because the corporation may be operating under a different name publicly. Also, merely filing the appropriate documents with provincial or federal government does not confer rights in a trade name unless the business is actually using it as such and, in the event of a dispute, the party that first used the name as a trade name will be deemed to be the owner. Thus, in the context of selling a business, it is important to carefully parse out what is being used as a trademark or service mark on the wares or in connection with the services, what is being used as trade name, and then determine whether that trade name is the same as the corporate name. Once all of these interrelated assets have been identified, the parties can more effectively address each of them in the transfer documents.

6. Trade Secrets

A trade secret is any information that (1) derives independent economic value from not being generally known or ascertainable by proper means; and (2) is the subject or reasonable efforts to maintain its secrecy. Trade secrets may be chemical formulas, manufacturing processes, sales methods, distribution methods or lists, consumer profiles, advertising strategies, lists of suppliers, software, physical devices, etc. In order for a company's information to be considered a trade secret, the company must take reasonable steps to keep the information secret. Typical steps include the use of nondisclosure agreements, non-solicitation agreements, covenants not to compete, policies affirming ownership and confidentiality, and security controls such as passwords, identification cards, encryption, physical security, etc., that limit access to the information.

When selling a business or transferring a specific asset that involves a trade secret, the parties should confirm that the nondisclosure agreements, policies and procedures, and security measures have been put into place. Failure to do so may result in the dismissal of a claim for misappropriation of the information by a former employee or a competitor. Both the buyer and the seller should also develop a plan to transfer and document any experiential and informational expertise, or "know-how," of key employees. Even if the parties have taken all measures to protect valuable trade secrets, if the buyer cannot retain the key personnel necessary to implement the trade secrets, then the value of the deal to the buyer may be substantially reduced. This might be particularly important if the key employees are near retirement or are highly sought-after in the industry. Thus, it might be useful to enter into employment contracts with key employees.

7. Copyrights

While ownership interests in copyrights are not typically the primary assets being transferred in most business transactions, they can often arise in the context of customized computer software, websites, and electronic images. The parties transferring copyright assets and performing the due diligence search should be aware of several aspects of copyright law. First, a copyright exists once it is "fixed in any tangible medium of expression," regardless of whether the work has been registered with the CIPO. The ownership of a copyright initially vests in the author or authors. A copyright does not subsist from the date of its registration or the date at which notice of copyright is affixed, as is all too commonly believed.

Second, to validly transfer an ownership interest or exclusive license in a copyright, the transfer must be made in writing. Therefore, it is important that the purchaser get a written assignment from the author. Nonexclusive licenses, however, may be given orally or even implied from the conduct of the parties.

Third, if the question arises whether the work was a work made for hire, it is imperative to carefully review the Copyright Act to determine whether the work meets the definition of a work made for hire. If a work made by an independent contractor does not qualify as a "work made for hire," the copyright is owned by the independent contractor and a written assignment is necessary.

Fourth, joint authors who have not each individually assigned their rights to the work may each personally exploit the work, assign their rights to the work, or license the work without the other author's consent, but must account to the other authors in proportion to the percentage owned. Thus, in the case of joint authorship, the parties should ensure that the seller has an assignment from all of the authors. Otherwise, the buyer may find that the remaining authors have granted a license or assigned their rights to a competitor. If the seller does have full ownership, the terms of the transfer agreements should include a warranty of actual title, stating that neither the work nor any part thereof is in the public domain.

8. Patents

Proper due diligence is especially important in transfers involving patent assets. First, patents have attributes of personal property and, as with a copyright, the ownership of a patent initially vests with the inventor. However, a company may obtain title if the patent is assigned to the company by written instrument.

Second, each inventor or owner has the right to exploit the invention without the consent of the other inventors or owners. Therefore, in a due diligence inquiry, it is critical to identity the inventors and verify that the seller has obtained assignments from each of them.

Third, patents are unique because they are negative monopolies, meaning that the owner of the patent has the right to exclude others. Further, since the claim scope of two different patents can overlap, company's device or production method may be covered not only by its own patent, but also the patent of a third party. As a result, once ownership in any patent or filed application has been verified, an infringement search should be performed by reviewing the closest known patents to determine whether the seller's assets pose a risk for a patent infringement claim by a competitor. This may be important if either party has a particularly contentious relationship with its competitors. Alternatively, the buyer may insist that the seller provide warranty and representation that the patents and filed applications do not infringe a third party patent.