

**Living (La Vida Loca) Under Your NDA:
Diligence in Preliminary Merger & Acquisition Evaluations**

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LIVING (LA VIDA LOCA) UNDER YOUR NDA: DILIGENCE IN PRELIMINARY MERGER & ACQUISITION EVALUATIONS

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I. Introduction

After conducting the initial due diligence using public information to obtain and evaluate the intellectual property rights of a potential merger or acquisition target, you have entered a Non-Disclosure Agreement (NDA) to engage in more intimate discussions with your target to continue the deal process. While publicly available information may have been sufficient to generate internal interest in approaching the potential target, the next step involves receiving some of the target's confidential information for evaluation to make intelligent and informed business decisions about whether to enter a letter of intent. This article discusses some of the strategic considerations that should be taken into account in conducting this preliminary IP diligence under the NDA, and the dangers that arise when the deal terminates short of consummating the expected transaction.

II. Evaluation of Confidential Information Under the NDA

Typically, the NDA protects non-public business information that is of the most value to a company. It is often the case that this information is similarly valuable to a company's competitors, which can lead to unexpected tensions when competitors contemplate, but do not follow through, with an acquisition or merger. While there is often a flow of information in both directions in contemplating a merger or acquisition, typically the bulk of information flow is from the target company (seller) to the acquiring company (buyer). Accordingly, the discussion below will often refer to the "target" when referring to the party disclosing information, and the "acquiring company" when referring to the party receiving the information.

Under the NDA, the target can convey valuable information for evaluation by the acquiring company while retaining a mechanism to minimize the risk that the acquiring company, or someone affiliated with it having access to the information, will steal or use the information without approval, such as for purposes beyond the deal evaluation. Some of the main goals of due diligence at this phase of a deal are to identify all non-public intellectual property assets, confirm title to owned assets, confirm viability and scope of licensed assets, ensure that these assets are free of technical defects or encumbrances, and ensure that the assets are transferable. Having a suitable NDA in place furthers that goal by allowing the acquiring company to review non-public information from the target that it would otherwise not have access to.

To identify and locate all the intellectual property assets of the target company, the acquiring company should consider submitting a due diligence request for information under the pre-Letter of Intent NDA regarding all relevant intellectual property rights (IPR) and other issues discussed in part below. Relevant IPR may be owned by the target (in whole or in part), or licensed in or

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out of the target. Particularly important to obtain for further evaluation are any non-public, material IPR, including the following:

- unpublished patent applications and the file histories to date;
- improvements on patented technology;
- invention records and related documentation;
- all unregistered trademarks, service marks, trade dress and product configurations, logos, trade names, corporate names, and all other indicia of source;
- all unregistered works of authorship;
- all computer software, data, and documentation;
- all trade secrets and confidential business information, including know-how, formulas, drawings and technical plans, schematics, prototypes, designs, models, data and databases, and manufacturing and production processes and techniques;
- licenses relating to all IPR licensed into and out of the target; and
- important litigation filings that are under seal (which may require modification of a court order).

In addition to identifying the target's IPR, the target's future marketing plans and any competitors' IPR should also be assessed. If the target has performed a freedom to operate analysis and is open to providing that analysis, this should also be reviewed to ascertain the risk of future litigation. Other areas that may require diligence from an IP perspective include the following:

- future product launch plans;
- landscape evaluations of third party patent and trademark rights;
- opinions regarding any owned IPR, licensed IPR, and third party IPR;
- main thrust of any R&D efforts; and
- competitive intelligence gathered on main competitors.

In some cases, the target may not be willing to disclose some of the more highly sensitive categories of confidential information before a Letter of Intent, or even a definitive Purchase Agreement, is in place. For example, a target may be reluctant to reveal future product plans and opinions of counsel until the proposed relationship is closer to being cemented. Before receiving any opinions of counsel, care must be taken to try to preserve the attorney-client privilege. This loss of privilege can weaken the enforceability of the target's IPR whether or not the deal proceeds. Any opinions of counsel that are obtained through diligence should be reviewed carefully and evaluated to determine the resulting impact to the value of the target's IPR, as the opinions may result in the target's IPR, products, and services having significantly lesser (or greater) value.

Yet another task for the acquiring company is confirming title of the target's IPR. While most of this information may be available on public websites, it is a good practice to request any assignments, consulting agreements, and employment contracts that trace inventorship and the chain of title to the seller. If obtaining or reviewing all the specific agreements is too burdensome for either or both parties, an exemplary agreement of each type coupled with written assurance (and the proper representations and warranties in the definitive agreement) by the

target that all personnel of that category (manager, officer, employee, consultant, etc.) are bound by a substantively similar agreement may be sufficient. There are also in- and out-licenses of IPR, which are rarely public unless they are material to a company or exclusive licenses, which are sometimes recorded.

While checking title to IPR should be unnecessary, surprisingly, more than 90% of the deals we have handled for clients have had multiple title defects in the IPR owned by the target. Unfortunately, some companies look at patent and trademark legal work as a mere commodity instead of a core asset of the business and, therefore, do not allocate proper resources to using best practices in securing their IPR. Many of these deficiencies are the result of mere oversight, and are often corrected by the target during the diligence phase. Examples of this type of correctable problem include corporate name changes or mergers without consequent updating of U.S. Patent & Trademark Office (USPTO) records, and failure to record the termination and release of security interests in one or more IP rights.

One type of more significant problem uncovered in past deals is the failure of one or more inventors to assign, or to properly assign, rights to the target or a predecessor entity. In one case, an inventor assigned rights to a completely unrelated entity. These problems can be correctable if the employee is still working for the target or if an agreement with an ex-employee can be reached, which may involve a payment to provide the proper incentive in exchange for an assignment. But when there is no employment agreement (or there is an employment agreement that does not contain preferred provisions regarding disclosure and assignment of IPR to the target) or no agreement is reached with an ex-employee, the target may not be able to guarantee exclusive ownership of a critical patent and the deal may unravel or the target may be worth significantly less. If such a patent had only the one inventor, it may even be possible that a product line will need to be shut down or carefully redesigned to avoid potential infringement.

Moreover, to determine the scope of the target's rights, any existing agreements that involve the transfer of IPR, including licenses, material transfer agreements, and collaboration agreements, should be examined. In one problematic diligence, it was uncovered that the key technology of the target was unpatentable despite a pending PCT application. The deal was restructured so our client ultimately paid only 5% of the multi-million dollar original valuation. In addition to the financial discount, the value drivers of the customer list and know-how of its newly acquired employees made this a deal worth concluding for our client despite the lack of patent protection.

Another important aspect to the diligence is competitive intelligence and the associated licensing and partnering potential of the target's technology. There may already be documentation regarding potential infringement of the target's IPR by a third party, or potential infringement by the target of a third party's IPR. Care should be taken to evaluate the progress and level of success in pursuing any potential infringers with the target's IPR, as it can often quickly highlight one or more scope, enforceability, or validity problems. Where third party IPR is concerned, an opinion of counsel and potentially redesign of target products or services may be needed to help manage the business risks of being charged with infringement.

III. Violation of Other NDAs

While the acquiring company is free to request all the information needed to make an informed decision, the target must ensure that it is not itself violating any of its NDAs with third parties by providing the requested information. The target should provide as much information as willing and as possible, but without disclosing another party's confidential information.

In one transaction, we collectively determined through three-way interviews with one of the acquiring company's engineers and the target's founder that the founder had apparently cobbled together the target's key technology from confidential information derived from prior positions at other companies. This deal ultimately proceeded to completion under very different circumstances, and our acquirer had to ensure that it did not make use of the improper confidential information in the target's possession.

IV. Strategic Considerations in Determining Who Evaluates Confidential Information

If the deal is consummated, litigation tends to occur when the financial terms end up being less favorable than expected, *e.g.*, due to changes in market conditions. Generally, however, litigation is less common due to problematic IPR when the deal is consummated. If the deal terminates short of closing, however, the target may be harmed (*e.g.*, public-company targets are typically harmed at least in terms of stock price) and may often look for a culprit. The most likely culprit is the would-be acquirer and its personnel, all of whom may now become the new "target" in a breach of contract action. The jilted target may argue that the acquirer or its personnel took and misused information received in confidence that was to be used only for evaluation purposes under the NDA.

In this context, the nature of the acquiring company and the target selling a portion of its assets or its entire business, and their pre-deal relationship, must be taken into consideration. An acquirer that is an acquisition fund or an indirect competitor of the target is less likely to face accusations of wrongdoing because the acquirer is less likely to be conducting significant R&D, selling competing products, or pursuing patent applications in connection with their existing assets.

In situations where the acquiring company and the target are direct competitors or could become direct competitors—as is often the situation in proposed acquisitions and mergers that make the most sense—the risk of suit is greater. Thus, in these situations, it is more important to implement and conduct this phase of diligence as if the deal might be terminated early. Most NDAs include a provision that restricts the use of the confidential information solely to evaluation of the proposed transaction. Yet a jilted target may allege—sometimes legitimately—that further developments of the would-be acquirer are so substantially similar that they were derived from improperly used confidential information. As evidence, the jilted target often need only point to the inventor(s) of the new technology, coupled with the fact that the identical inventor(s) were on the diligence team that had access under the NDA to the target's confidential information. Under such circumstances, it will be difficult or perhaps impossible for the

acquiring company to prove it conducted truly independent development and that no confidential information was used in developing the new technology.

In view of this serious consequence, a target may sometimes insist on an NDA provision that restricts access to its confidential information so that technical personnel of the acquiring company, or any personnel of the acquiring company, cannot participate in this diligence phase. Even if this provision is not present, in view of the above-noted concerns, it may still be wise for the acquiring company to consider forming a diligence team that does not include the acquiring company's technical personnel, managers, and sometimes even its attorneys. This helps manage the business risk that may arise from successful technological developments by other employees or consultants of the acquirer following a failed deal. This need for segregation is particularly true for those personnel and outside counsel that engage in inventive activities or patent prosecution for the buyer.

For a sufficiently large acquiring company not under any particular restrictions from the NDA as to who internally may review confidential diligence materials from the target, one possibility is to arrange for technical staff to review materials that are outside their typical job responsibilities. Another possibility is to have one or more technical employees who participate in all deal diligence to keep this work segregated from the technical staff developing inventions and the personnel or counsel involved in patenting further technology developments. This can bolster a defense (or lead to a quick settlement) when the would-be-acquirer can show the relevant personnel or counsel never saw—or never had access to—the target's confidential information. This strategy becomes more difficult for smaller acquiring companies that may not have sufficient technical staff for such a dual-track arrangement.

In those situations, a solution to this problem is to have outside counsel conduct the diligence review and provide only reasoned conclusions without revealing the relevant underlying confidential information. Of course, if diligence counsel is the same as prosecution counsel—possibly even if the lawyers are partners at the same firm—the accusation of misuse of the target's confidential information would simply shift from the acquiring company to its law firm or other representatives. The concern here is that patent counsel who reviewed the target's confidential diligence materials may prepare a draft application based on the acquiring company's later developed technology, and may accidentally inject improvements or suggestions that arise from the target's confidential information. Because patent counsel is so involved in the drafting of patent applications, it can be difficult to neatly separate information. This issue can be avoided by using competent IP counsel to conduct the diligence that is not actively involved in protecting the acquiring company's intellectual property. Another tactic for acquiring companies of any size is to instruct its inventors to carefully document dates of conception of an idea and reduction to practice, as it may be that the invention arose before the confidential information was revealed to the acquirer as part of the diligence. Of course, such recordkeeping is an essential part of the best practices for protecting IPR in any event.

In view of these concerns, there is a substantial justification for acquiring companies to limit the number and type of people that have access to the target's confidential materials under the NDA. Another strategy is to phase the diligence so the target does not reveal its business critical trade-secrets or other confidential information until later in the diligence, and preferably not until after

a definitive agreement is signed with the necessary contingencies for further IPR diligence. At that time, the deal is more likely to proceed to closing and the risk of a failed deal is lower.

Another reason an acquiring company should be careful of who reviews the target's confidential information is the triggering of the Rule 56 disclosure obligations to the USPTO. Under Rule 56 of the Code of Federal Regulations, a patent attorney and others closely involved in the prosecution of the patent are required to disclose all information that is known by that individual to be material to the patentability of the claimed invention. Consider the situation where, during review of the target's confidential information, material information surfaces that reveals that the claims of one or more of the acquiring company's patent application(s) are unpatentable. Patent counsel and others associated with a pending application who reviewed the confidential information are then obligated to disclose that information to the USPTO under the Rule 56 disclosure requirements. This obligated disclosure of the confidential information to the USPTO may create a breach of contract action against the acquiring company under the terms of NDA. On the other hand, if patent counsel chooses not to disclose this information, he or she runs the risk of obtaining an invalid and an unenforceable patent based on charges of inequitable conduct. Further, if patent counsel elects not to disclose the information, patent counsel also personally risks ethics violations.

V. Compliance with the NDA Provisions

If the transaction is successful, typically the acquiring company can freely use the confidential information of the target following closing to operate the ongoing business. But in the wake of an incomplete deal, there are some typical NDA provisions that require careful attention to help ensure the jilted target is not provided with good cause to sue for breach of the NDA.

Importantly, consideration should be given to whether the confidential information provided to the acquiring company must be destroyed or returned to the target automatically or only upon request. While financial, market, and even some customer information may go stale with the passage of time, proprietary technical information and know-how may be valuable for decades. In addition to the timing issue, there are good reasons discussed above that weigh in favor of destroying or returning any confidential information following a failed transaction.

One common NDA provision requires the acquiring company to provide prompt notice of any court or governmental agency action requiring disclosure of confidential information in order to provide the target an opportunity to seek a protective order and to narrow the scope of the disclosure. Importantly, the NDA language from the diligence will be helpful in determining what actions should be taken, as the NDA should indicate whether the acquiring company must be *compelled* before it can disclose confidential information or whether it merely needs to have received a *request* for the information in a legal proceeding.

Another provision that can wreak havoc on a would-be acquirer in the event of deal failure is the inclusion of vague or exceedingly strict prohibitions on the use of confidential information received. For example, is the information permitted to be used only for the evaluation, for any legitimate purpose under the agreement, or "not in any way detrimental to the disclosing party"? This last phrase is fairly vague and may give rise to spurious charges by a jilted target. For

example, the acquiring company may terminate a potential deal with the first target and pursue one with a second potential target. The first target may argue that information gleaned during diligence led the acquiring company to terminate negotiations and pursue a different target, thereby using the information in a way detrimental to the first target.

Yet another compliance issue tends to arise in situations where the NDA from the failed deal requires the acquiring company to treat all information disclosed by the target as being subject to the terms of the NDA, not just the target's non-public information. Efforts should be made when entering an NDA to seek language limiting the confidential information to non-public, confidential, or proprietary information.

It is also critical for an acquiring company to share the target's confidential information only with permitted recipients under the NDA. Poorly worded NDA language limiting the permitted recipients to consultants may not include finance sources who would want to review this information before committing to funding the proposed transaction. There are other NDA provisions that should also be carefully reviewed to ensure compliance by the acquiring company.

VI. Conclusion

Careful consideration needs to be made of what an NDA will prevent you from doing, and what limitations exist on actions you can take with the confidential information you received as the acquiring company or its counsel. This is particularly true when weighing obligations to disclose information against the restrictions of an NDA in a merger or acquisition deal. When care is taken to avoid onerous NDA terms and to select an appropriate diligence review team, many of the serious problems that arise from an NDA that survives a failed deal can be minimized or avoided completely. But certainly, these potential problems strongly weigh in favor of conducting diligence from available public information before even entering an NDA, and in taking care to follow the obligations set forth in the NDA thereafter to minimize the increased risks inherent in a failed deal. Ultimately, these concerns provide a significant incentive to enter this phase of merger or acquisition diligence only if there is an expectation of taking the deal to completion.