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The Top Five Intellectual Property Traps in M&A Transactions

Article By:

Intellectual Property Practice Group

In M&A transactions, many lawyers assume that intellectual property (IP) rights will automatically transfer with the purchase and that IP issues can be cured by general representations and warranties. While getting strong representations and warranties covering intellectual property is useful, relying on a breach of representations and warranties as the only remedy to protect the covered IP can doom the deal to failure or lead to unexpected surprises after closing, including requiring significant changes to future business plans and opportunities. If the target's IP rights are important to the ultimate deal, then those IP rights must be investigated thoroughly in the due diligence and fully understood.

A due diligence investigation into a company's intellectual property assets is essentially a methodical audit which will cover at least the following main areas:

- Patents
- Know-how
- Copyright
- Trademarks
- Infringements
- Licenses and collaboration agreements

Failure to examine these during due diligence in a manner appropriate to the deal at hand can lead to reevaluation, repricing or structural changes of the transaction.

For example, Volkswagen outbid BMW in 1998 to buy Rolls Royce and Bentley and their British factory from Vickers PLC for $917 million. But an odd twist in the deal allowed the Rolls-Royce aerospace company to sell rights to the ROLLS-ROYCE trademark to BMW out from under Volkswagen for $78 million. Thus, after the deal closed, Volkswagen did not have the rights to use the ROLLS-ROYCE mark. Only after a separate deal was made with BMW to avoid litigation, did Volkswagen gain the ability to manufacture a trademarked ROLLS-ROYCE car.

Thus, IP due diligence in an M&A transaction should not be overlooked and should be undertaken early in the process. The following are five common IP issues that may impact M&A transactions.

1. Target Does Not Actually Have the Critical Patent Rights

A target company may not actually own the IP rights that it represents that it owns. This may be due to a failure to update the title through corporate name changes or lien releases, or a failure to ensure that employees have properly assigned their rights to IP assets developed with company resources to the target. This latter situation is particularly problematic. For example, under U.S. patent law, each joint inventor has the right to use and to license patented technology to a competitor *without* accounting to the other owner in the absence of an agreement to the contrary. As a result, a non-assigning employee can license a key competitor of the buyer (and even keep the royalties) without notifying the target. The problem can be more acute in the case of an independent contractor, who may not have an obligation to assign rights to the target. It is therefore important to review contractor agreements related to any IP relevant to the transaction to confirm that the agreements address ownership of any IP created by the contractor.

Trademarks must be evaluated in terms of their goods, services and countries of registration to confirm that they cover the buyer's intended uses in intended markets. Certain countries recognize common law trademark rights, based on use of a mark, while other jurisdictions give priority to the first party to file a trademark application, regardless of use. Internet domain names are subject to fewer formalities, but must be investigated as well. Domain name registrations may expire and, if expired, the domain names can be bought by anyone. It is also important to confirm that important domain names are owned by an entity relevant to the transaction, as opposed to an information technology (IT) professional within the company, a licensee or another entity.

2. Prior Agreements Limit IP Rights

Sometimes, the target's IP rights may be subject to prior agreements that restrict their use in other markets or fields of use. The target may have existing licenses or agreements with respect to some or all of its IP rights. For instance, the target may have granted a third party exclusive use in a key field of use, territory or patent, which may limited the buyer's full and expected use of the IP rights.

For example, when the Clorox Company purchased the PINE-SOL business and trademark from American Cyanamid in 1990, Clorox planned to leverage the strength of the PINE-SOL mark into other products. Clorox purchased the PINE-SOL assets and mark subject to a prior 1987 agreement that Cyanamid had entered into with the owner of the LYSOL trademark to settle a trademark dispute years earlier. That prior agreement restricted Cyanamid (and subsequently Clorox) from expanding the use of the mark beyond the PINE-SOL pine cleaner. Clorox tried to void the terms of the settlement agreement through litigation, but was unsuccessful.

Licensors of intellectual property may argue that a merger in which a licensee does not "survive" as a separate corporate entity may void the license – even if the license agreement contained no prohibition against merger, acquisition or transfer. This argument is based on an arcane line of federal cases holding that patent licenses are not assignable unless expressly made so. More recently, some federal courts have extended this rule in ways that affect corporate mergers, and have found, in effect, that certain mergers can constitute transfers that void patent licenses. This is especially problematic in an acquisition of a licensee.

Additionally, in certain instances in which the U.S. government has provided funding to an entity (usually a nonprofit, university or small business), the U.S. government may retain certain rights to any relevant patents developed from that research, and any subsequent grants relating to those rights (*e.g.*, a license or acquisition) will remain subject to the government's retained rights. These government "march-in" include the right to license the invention to a third party, without the consent of the patent holder or original licensee, where it determines the invention is not being made available to the public on a reasonable basis.

3. Target is Subject to Pending/Threatened Infringement Claims

No buyer wants to buy an expensive IP-related lawsuit through an acquisition. Any potential litigation or enforcement risks must be assessed and independently analyzed, including evaluating potential indemnifications. Although others exist, two primary areas for inquiry in this context include potential patent infringement and copyright liabilities.

For potential patent liability issues, a purchaser does not want to spend a great deal of time and money to acquire rights that it will not be able to exploit because of third party's potential infringement lawsuit. Potential litigation and enforcement risks may be identified through the target's legal opinions, cease and desist letters, freedom to operate studies and similar materials, which should be requested and analyzed in the due diligence process.

As to open-source software, the GNU General Public License governs a large number of open-source products. Open-source code can only be tightly integrated into other open-source products, and a condition of using the code is that the user also publishes its modified version of the code to the public. The Free Software Foundation enforces the GNU General Public License. This can be problematic in an acquisition, especially when the software is a valuable piece of the assets being acquired. There have been instances where an acquiree has been sued by the Free Software Foundation after acquiring a company that had allegedly incorporate open-source code into its software. In at least one instance, the acquirer had to release the acquired software to the public as a result. Open-source liability can kill a deal and affect the value of a transaction. In the absence of insurance, some companies will accept a reduction in deal price.

4. Significant Barriers Exist to Exploitation of the Technology

With regard to patents and the ability to exploit the acquired patented technology, significant barriers may exist. Third parties may have blocking IP rights that prevent the buyer from exploiting the target's IP or expanding the business as planned. Sometimes, this risk is not specifically known even to a target. Thus, the buyer's freedom to operate often should be analyzed before completing the transaction, to make sure that the buyer will be able to use the assets purchased as intended in the conduct of the business operations, or as proposed to be used according to the buyer's future plans. A freedom-to-operate analysis should be performed, which is an assessment of whether making, using sale, offering to sell or importation of a product in the U.S. will infringe any third-party patents.

If third party IP rights are identified that may block or limit the buyer's use of particular IP rights, and a meaningful design-around is not possible, then it may be necessary to license or acquire ancillary rights to such third party blocking IP rights. Alternatively, the target could seek to invalidate the blocking IP at the United States Patent and Trademark Office (*e.g.*, through a reexamination) or in a court. The inquiry is more complex when pending claims are published yet not issued, so the inquiry not only requires construction of the claims and infringement analysis, but also estimation of whether the published claim(s) will issue. Evolving application of infringement under the doctrine of equivalents and other changing legal standards through judicial decisions only adds to the complexity and cost of the analysis.

Of course, this still leaves unknown barriers to the exploitation of technology. Included in this category are issues such as unpublished patent rights that could block a buyer, misappropriation of technology, reverse engineering by competitors who have then patented improvements to a target's trade secrets or even competitors who independently discover trade secrets and patent them, and the like. To the extent these can be explored, it is wise to do so. However, there are risks in any deal, and wise IP counsel can consider the impact of potential unknowns based on the industry and technology involved in the contemplated transaction.

5. Target's IP Rights Are Encumbered by Liens

IP rights may also be encumbered by liens. To record and perfect a lien against both patents and trademarks in the United States, Uniform Commercial Code (UCC) filings need to be made. Although not legally required, most lenders also record the security agreement in the U.S. Patent and Trademark Office (USPTO). Under U.S. copyright law, however, only a lien recorded in the U.S. Copyright Office will perfect a security interest in copyrights. Due diligence should include reviewing reports from all of the applicable filing offices.

In sum, early and comprehensive IP due diligence in M&A transactions is important because it can lead to a reevaluation, repricing or restructuring of the proposed transaction.

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