

**DUE DILIGENCE IN FINANCIAL
TRANSACTIONS INVOLVING
KNOWLEDGE-BASED COMPANIES**

*Super Transactions Conference
May 22 and 23, 1996*

by
[Darren E. Sukonick](#)

INTRODUCTION

Once the parties to a transaction have agreed on the basic terms of their agreement or engagement, one of the parties (i.e., the buyer, the lender, the underwriter) will have a period of time to review all of the information pertinent to the business. This process of investigating the business, legal and financial affairs of a company is what is generally referred to as "due diligence".

The extent and the nature of the due diligence will differ depending on the type of transaction (i.e., acquisition, take-over, securities financing, bank financing) and the type of companies involved (i.e., financial institutions, real estate developers, manufacturers). However, almost every transaction will involve some intellectual property: at the very least, for example, the trade name of the business or the computer system on which the payroll information is stored. Transactions involving knowledge-based companies are usually highly dependent on intellectual property. Due diligence in respect of these companies must involve an extensive review of the company's so-called "intangible" assets.

One of the main reasons for due diligence is to ensure that nasty surprises are kept to a minimum. The purpose of this paper (and the accompanying checklist) is to provide an overview of the intellectual property aspects of the due diligence process for a knowledge-based company involved in a financial transaction. Clearly, some of the activities described below will not be appropriate for every transaction. Once the lawyer has an idea of the types of investigations that could be done, he or she can analyze the specific transaction and the nature of the company's business, assets and activities to determine which investigations should be done.

NATURE OF TRANSACTION/COMPANY

Before the lawyer can plan the due diligence process, it is necessary to answer some basic questions: What is your client proposing to do and why is your client doing it? Firstly, the answers to these questions will help the lawyer identify the type of transaction(s) that will be occurring. One must take into account not only the primary transactions (i.e., a share purchase) but all related transactions (i.e., a bank loan to finance the purchase, a spin_off of the assets and liabilities of a specific division or a license back of certain intellectual property). If the lawyer fails to appreciate the importance of significant pre- and post-closing aspects, the scope of the due diligence may be insufficient to protect the client's interests. Secondly, the lawyer must try to understand which parts of the transaction are most important to the client. Without a grasp of the client's perspective, the lawyer may fail to focus his or her energies on the proper areas. Alternatively, counsel may need to correct a client's misconception.

The lawyer will next want to gain an understanding of the specific business at issue and the industry in which that business operates. Getting to know the business involves two levels: (i) the key individuals and offices that will be involved in the due diligence process and (ii) the structure of the business on a macro level. On the first level, the lawyer will want to assemble a list of contacts: the business people behind the transaction, in-house counsel, technology and operational people, director of sales or marketing, production manager, etc. Occasionally the lawyer may need help from the client's or the other side's engineer or research and development staff. Counsel will need to know where information files are kept, where computer hardware and data is stored and which activities occur at different locations (i.e., physical plants). On the second (macro) level, the lawyer must identify all of the related entities involved in the business. In large businesses, these may include holding companies, subsidiaries, limited partnerships, and foreign offshore trusts. Later on in the process, the lawyer will need to determine how intellectual property is shared among these related entities; whether there are formal agreements and licenses or (more often the case) nothing in writing. In small businesses, a key individual

may also be the key source (and titled owner) of crucial intellectual property. If the business employs multiple locations or offices, intellectual property may reside in foreign jurisdictions.

Each business and industry can have different issues associated with it. For example, consumer product companies often rely heavily on brand names. Software and publishing businesses depend mainly on copyright. Pharmaceutical companies work within a highly regulated industry. While learning about the industry in general, you should also become aware of the business's major competitors and what challenges they pose to the business.

The lawyer must also look towards the future with respect to (i) in what directions the business seems to be heading, (ii) in what directions your client would like to take the business (i.e., after an acquisition the client may wish to change locations or product lines) and (iii) in what directions the industry as a whole seems to be heading.

SEARCHES OF PUBLIC RECORDS

Generally

Once the lawyer has pinpointed the important entities and intellectual property assets, she or he must, at an absolute minimum, check publicly available records of intellectual property which are material to the business at issue. However, the lawyer can only rely on these searches to a limited extent because (i) certain intellectual property need not be registered; (ii) some pending applications to acquire intellectual property rights are not available to be searched; (iii) important intellectual property rights which should be formally protected are often not; and (iv) records relating to intellectual property in public offices are often not up to date or are inaccurate. While searches of public records can be helpful, they are rarely comprehensive enough to provide the entire due diligence picture. As a further caveat, intellectual property rights are not the same in every jurisdiction. The scope of a patent, for example, may be narrower in one country than another.

Trade-Marks and Trade Names

A trade-mark is a word, symbol or shape (or a combination) used to distinguish one person's goods or services from those of others. In Canada, trade marks need not be registered but often are to ensure certain protection. In some other jurisdictions, trademarks must be registered to be enforceable.

The usual starting point and most common search is an "index search". This search should be done in the name of the company at issue and all relevant predecessor and related companies. It will reveal trade-mark registrations and pending applications for registration of trade-mark in the name of the particular person. It is helpful in establishing which trade marks enjoy (or may soon enjoy) protection under the registration system. Often, the index search will reveal that a specific trade-mark used by the company is not registered, and the lawyer will want to conduct a "registrability search". This will identify any issued registrations or prior applications for trade-marks similar to the one at issue. It will help the lawyer determine whether a trade-mark could possibly be registered if the mark is of sufficient value to make the exercise worthwhile. A "search for non-use proceedings" can be important because those proceedings may lead to a possible expungement of a registration and a consequent loss of registration protection. Although the standard searches will not reveal expunged registrations or abandoned applications, the searches can be expanded to identify these as well. If there is a significant major competitor, counsel may want to conduct similar searches in the name of the competitor and its related companies. An "opposition search" can uncover pending oppositions in which the company is opposing the applications of third parties.

In addition to the usual PPSA searches, the lawyer can look for security interests recorded against trade-mark registrations and applications; however, this information may not appear in the materials generally available for searching. It is necessary to review the file history of the relevant application or registration to determine whether a copy of a security document has been placed on file.

A trade name is the name under which a business is carried on. The lawyer should perform a NUANS search to identify all trade names of record which are similar or identical to any key trade names of the business at issue. It may be necessary to follow up by ordering corporate or business name records to get additional information.

Patents

Patents may be obtained for certain classes of new and useful inventions. However, the lawyer may often find that valuable inventions are not the subject of patent protection. This may occur because (i) the invention does not satisfy the criteria to obtain a patent, (ii) the company did not want to go through the time and expense of seeking a patent or (iii) the company missed the limitation period.

The first step is to determine which patents are protected, the quality of the patent and potential problems. As with trade-marks, the usual starting point is the "index search". The Patent Office keeps an alphabetical index of inventors, patentees and recorded owners, divided into groups of years (i.e., 1971-76; 1977-84) which must be searched separately. The index records what patents and published applications have been granted to, filed by or transferred to a particular person. Although the index search will not reveal expired patents, this information can be specifically requested. If the business is a small one involving a key individual or even a major business where most of the technology derives from a few specific individuals, it would be prudent to do an "inventor search". This search will locate all patents and published applications granted in the name of a specific inventor. To assess the strength of a particular patent, the lawyer would conduct a "validity search" which would locate patents and published applications that may affect the validity of claims of a specific patent. Because all patent applications are kept confidential until a registration issues, searches will not reveal any references to pending applications.

If a company is working in a new technology area, three searches may be of use. A "state of the art search" will find out the latest technology in a specific field. This search can be helpful to determine whether a business is devoting its time developing technology that is already obsolete or may run up against later patent problems. A "novelty search" is usually done prior to filing an application to check whether the invention is patentable but can also be done to check the patent prospects for new technology. An "infringement search" will reveal patents and potential patents that may be infringed by a new invention. Because it is expensive, however, it may only be worthwhile if a particular new product line is crucial to the success of the business. These searches all rely on the classification system maintained by the Patent Office. This results in much subjectivity which goes into any search and analysis.

Counsel must take into account foreign jurisdictions in two ways. Firstly, if a company carries on much of their business in a foreign jurisdiction, they are more likely to apply for patent protection in that jurisdiction. It is essential that the lawyer considers all potential jurisdictions (especially the United States) when ordering these searches. Secondly, the lawyer should be aware that a person can file an international patent application pursuant to the *Patent Cooperation Treaty* (the "PCT"). The application first passes through an "international phase" and then the applicant chooses to enter the "national phase" in some or all of the member countries which have been designated in the application. One can conduct

"PCT index and inventor searches" for pending international applications that have not yet entered the national phase.

With respect to security interests, unlike trade marks, all security documents filed in the Patent Office are recorded against the title of all relevant patents and applications. This search should be done in addition to the usual PPSA searches.

Industrial Designs

An industrial design registration can be used to protect certain shapes and patterns that have an original shape, configuration or ornamentation applied to a useful article. As with patents, many businesses will not register valuable designs because of expense, a missed limitation or a failure to meet criteria.

The lawyer will conduct many of the same types of searches as discussed above: index search, state of the art search, novelty search, infringement search and validity search. Information can be obtained on expired registrations if specifically requested. However, because all applications are kept confidential until a registration issues, searches will not reveal any references to pending applications. Since the *Industrial Design Act* requires the registration of exclusive licenses, a "license search" can be helpful in identifying any licenses of record against particular registrations. As with patents, certain searches are dependent on the classification system maintained by the Industrial Design Office, and this injects a large element of subjectivity into the search process.

With respect to security interests, like patents, all security documents filed in the Industrial Design Office are recorded against the title of all relevant registrations and applications. This search should be done in addition to the usual PPSA searches.

Copyright

Copyright grants to the owner the sole right to reproduce, perform or publish literary, dramatic, artistic and musical work. Copyright only protects the form of the expression; it does not protect the concept or subject matter. For a knowledge based company, copyright can operate to protect a number of important assets: manuals, sales and technical information, customer and supplier databases, software, catalogues, etc.

Copyright automatically attaches to an original work once it has been created and put in tangible form. Although neither notice nor registration is required, there is an optional system of registration which is not widely used. An "index search" in the Copyright Office can determine what registrations have been granted or transferred to a particular person. If a particular individual at the company has been responsible for much written material or software development, it is advisable to perform an "author search". This search will locate all works of registered copyright in which the particular author has been named. To get an idea of rights affecting the copyright, a "title search" will identify any licenses or grants of security interests that have been recorded against a copyright. If a particular work is material to the business at issue, a "work search" will reveal whether a certain work has been the subject of copyright registration.

Copyright searches should be done but are of very limited use. As mentioned above, copyright is rarely registered and the searches will often yield very little information. Work searches operate by title which can often be vague or misleading. As well, applications for registration are not available for searching.

Integrated Topographies

Topographies are three-dimensional patterns embodied in silicon chips. A creator can receive certain protections for the chip containing the protected topography or an industrial article which incorporates this kind of chip. While Canada has only recently introduced this legislation and there are few registrations recorded, the United States has had corresponding legislation for a longer period of time. When a lawyer is dealing with a business in the microchip industry, it is prudent to do the appropriate searches both in Canada and in the United States.

Other Rights

Certain valuable rights can not be revealed by the above searches. For example, moral rights restrict the modification or exploitation of a work after it has been sold or licensed. Moral rights cannot be transferred or assigned; however, they can be waived by the author, in whole or in part. In evaluating the worth of certain copyrighted works (i.e., software), the lawyer must take into consideration whether an author's moral rights could interfere with future modification or exploitation of that work.

Another example is personality rights which relate to the names, representations or distinctive features associated with celebrities (i.e., political, athletic or entertainment figures). Certain businesses are substantially dependent on these rights directly (i.e., music, poster or sports paraphernalia business) while others are indirectly dependent (i.e., use of a spokespersons to advertise products which are not based on personality rights).

Proprietary information represents yet another area of potential assets that cannot be uncovered through searches. This information includes confidential information, trade secrets and know_how. It is not only related to technical information but can include business and sales techniques, customer and supplier lists and databases, etc.

Software

Establishing the intellectual property owner of software presents a number of challenges. Firstly, most software is protected by copyright, and, as discussed above, copyright is generally not registered in Canada. Secondly, it is becoming more common for owners of software to apply for patent protection. Since the patent review process takes approximately eighteen months and since all patent applications are kept confidential until a registration issues, it is impossible to be certain that a given product is non-infringing. In addition, since the software industry is relatively new and the terminology is still unsettled, a lawyer may find it difficult to devise an appropriate search strategy. A further impediment is the high cost of certain patent searches (i.e., an infringement search), as discussed above.

INSPECTION OF PREMISES

Business Names and Marks

After discussions with the business's marketing personnel, the lawyer will want to review each of the products that is material to the business. This review involves a number of different elements: brand names, packaging and advertising. Through this exercise, the lawyer may uncover trade_marks or trade names that are unregistered, valuable copyright or personality rights or potential violations of the intellectual property rights of others.

Technology

One approach to the review of technology is to work from the bottom up. The lawyer would investigate how the business handles new ideas. Is it done through a research and development department? Who works in that area (in-house employees or outside contractors)? The lawyer will want to know how inventions are identified, evaluated and how rights in the intellectual property are transferred to or used by the company. This inspection should also reveal what products are new or improved and may soon be released. The lawyer can then determine whether the company is taking adequate steps to protect its new products at an early stage.

Computer Rights

To review this area, it is often helpful to identify tangible hardware assets. The next step is to discover what software is being run on that hardware. A physical inspection may also enable the lawyer to distinguish between equipment and software which is standard (i.e., commercial word processors) and that which is proprietary (i.e., a billing system customized for the particular business) and which may have a greater value and require more protection. It is helpful to go through accounting procedures, since these are often run through computer programs. Occasionally, this type of software may have been developed by or for the business. However, a company will rarely own much software unless it is a software developer. In that case, the software should be evaluated as technology, discussed above.

In larger companies, technology systems are often shared (i.e., the accounting for all subsidiaries is run through the parent corporation). The lawyer must determine how certain procedures will be handled after closing (i.e., upon a sale of a subsidiary), where company data is located and what interim arrangements will be made.

Copyright

Since copyright searches are often unhelpful, the physical review of material which may be subject to copyright is quite important. Aside from software and advertising material, dealt with above, a lawyer should review any plans, manuals or reports produced by the business. The lawyer must determine whether the material was produced by in-house employees or outside contractors and (as described below) review their contracts to ensure (i) that intellectual property rights remain in the company and (ii) that any applicable moral rights have been waived.

Proprietary Information

In the course of reviewing the business's operating procedures and organization, the lawyer will come across various proprietary information (as described above). After determining the ownership of the information, counsel should evaluate the ways in which it is protected. Discussions with personnel should reveal where the proprietary information is located, who can access it and what safeguards are in place to prevent unauthorized dissemination (i.e., both physical and contractual).

REVIEW OF CONTRACTS

Material Provisions

The lawyer will need to obtain and review all material agreements that involve intellectual property. A good approach is to focus on the business relationships that are built around intellectual property and try to find the written agreements (as well as appendices, schedules and side letters) that

govern those relationships. A lawyer will note the usual matters: what is the term; what happens at the end of the term; when can the contracts be terminated; are the contracts in good standing. In addition, the lawyer should identify any restrictions on (i) assigning rights under a contract, (ii) changing control of the company or (iii) sublicensing. As well, some intellectual property businesses operate internationally (for example, through the use of tax havens) and this may result in unusual withholding tax or other tax provisions.

Types of Agreements

There are several types of agreements that will be of greater importance for a knowledge-based company than for other types of companies. Confidentiality/secretcy, non-competition and non-solicitation agreements will be used to contain transmission of proprietary information. It is important to check when and how the contracts can come to an end (i.e., on a change of control) and whether they can be assigned (i.e., as part of a purchase of a business). License agreements must also be checked for change of control and assignability provisions. If a material part of the business is connected with its licenses, the lawyer must carefully review the terms (exclusivity grants, financial considerations, restrictive covenants, etc.) to form an opinion on the value of the license. Franchise agreements may contain a number of ancillary agreements, including lease or sublease arrangements, guarantees, etc. As well, restrictive covenants, assignment and change of control provisions are typically more onerous in franchise agreements than in license agreements.

When reviewing research and development agreements, it is necessary to review expired agreements in addition to current ones. A review of expired agreements will assist the lawyer in determining whether the transfer of intellectual property was properly dealt with in the past so as to ensure that those rights reside in the business in the present. In advertising agreements, as well, the lawyer must check main agreements and subcontracts to ensure that all intellectual property (especially copyright) was transferred to the business. It is also advisable to check whether these contracts have provided for waivers of moral rights.

Other agreements include: distribution and supply agreements, co_packing agreements and joint venture agreements.

Hard/Soft Technology

When considering computer hardware, the lawyer will want to compile a list of the equipment used in the business and whether that equipment is owned or leased. In either case, there will usually be maintenance contracts. Lease agreements and maintenance contracts must be reviewed to determine if there are restrictions on assignment or consequences upon a change of control or other major transaction.

Similarly, software must also be itemized and counsel must determine whether it is general purpose software licensed by the business or whether it has been custom developed. If it was custom developed, the lawyer must next check if it was created by employees or independent contractors and, in either case, ensure that the agreements providing for the software development adequately dealt with transferring intellectual property rights and waiving moral rights. It is also prudent to review any software maintenance and support agreements and software and hardware disaster recovery arrangements to see whether they can be assigned or whether there are consequences upon a change of control or other major transaction.

Employees and Contractors

In a knowledge based company, the most vital asset may be the company's human capital. The review of employment contracts is a crucial part of the due diligence process. The lawyer must review individual contracts as well as any policy manuals that may be incorporated by reference. Generally, intellectual property developed by an employee during the course of his or her duties will be owned by the employer. Nonetheless, many agreements will deal with the assignment of intellectual property and with the employee's continuing obligations to assist in the protection of those intellectual property rights. Employment agreements should also address moral rights and restrictions on the use of confidential information. Many employment contracts will restrict the right of the employee to solicit employees, customers, suppliers or others with whom the business has ongoing relationships. Non-competition clauses are also common; counsel must review such clauses to ensure that they are not unlimited in duration or geographical location and, therefore, potentially invalid.

Intellectual property developed by an independent contractor is presumed to remain with that contractor. It is even more important to review contracting arrangements to ensure that the above safeguards are present.

LITIGATION REVIEW

Company Personnel

Generally, the lawyer's first step will be to discuss the issue of litigation with the business's intellectual property counsel, general counsel or internal administrator. These people should have a good idea of what actual and potential conflicts exist. They can also provide counsel with litigation files which may contain actual claims and/or correspondence. The lawyer will not only wish to review actual litigation but any threatened litigation and any material conflicts which have been settled. Counsel should also specifically request that the company provide any opinions of legal counsel that may have been produced regarding threatened claims or potential infringement.

Search of Courts

If the lawyer cannot speak to these people (for example, in a hostile takeover situation), the lawyer will want to search courts of the relevant jurisdictions to determine if actual proceedings have been commenced. Since most intellectual property disputes go through the Federal Court, it is prudent to search its records. As well, one should search whether administrative litigation has been launched through the patent or trademark offices (i.e., oppositions, conflicts or appeals).

REVIEWING THE FINDINGS

After completing the investigative activities described above, the lawyer will have a fairly complete picture of the intellectual property position of the company. Counsel can compare the search results to what has been uncovered during the inspection and review of the contracts. At the end of the process the lawyer should be able to conclude:

- to what extent material intellectual property is owned or leased by the business, what steps the business has taken to protect this property and how effective those steps have been and continue to be;

- what problems currently exist in the company, either through deficient transfers of intellectual property, the failure to protect certain intellectual property or the alleged infringement of the intellectual property of others; and
- what problems would likely arise during the course of the proposed transaction (i.e., difficulties in assigning rights or agreements or adverse consequences upon change of control or other significant transactions).

These findings would be communicated to the client who can decide what steps should be taken: for example, abandoning the transaction, revising agreements that form the basis of the proposed transaction, attempting to correct certain deficiencies, etc.

CONCLUSIONS

Through the due diligence process, the lawyer endeavours to gather information to evaluate the benefits and the risks inherent in proceeding with the transaction. Especially in a knowledge-based company, the values of the underlying businesses and assets are highly dependent on the legal structures in place: registrations, contracts, etc. Although not all of the above procedures are necessary in every financial transaction, the lawyer should obviously err on the side of caution in forming the picture which is the basis of the advice to his or her client. This paper (and the accompanying checklist) should provide some guidance on when and how to carry out those procedures.

This memorandum is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues raised by this memorandum with you in the context of your particular circumstances.