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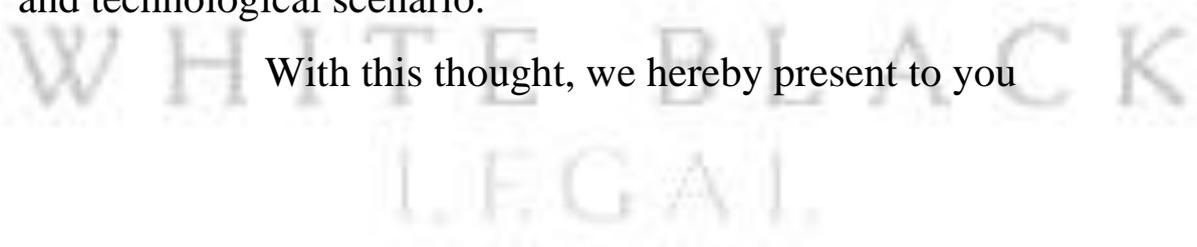
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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal provided dedicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you



DUE DILIGENCE AND TRANSFER OF INTELLECTUAL PROPERTY IN AN M&A TRANSACTION

AUTHORED BY - ANISH V & SAI AASHEERWA GUDLA

In this fast paced and business-oriented world, the rate of rise in the number of equity transactions have been at the highest they have ever been which is also duly reflected in the upward trend of the deal values of the Mergers & Acquisition deals that go through. The development of the current business environment has led to the adaptation of numerous technologies and various other products derived from the human intellect. This has given a boost to the aspect of Intellectual Property in the business world. Intellectual Property is a crucial aspect to a business or trade. Various trademarks, copyrights and other protected intellectual property is key to development and profitability of a venture. In this innovation driven environment, there can be no successful venture without making the best out of the protection and the scope of profitability given by the Intellectual Properties of a company. At this juncture, there comes the issue of transfer and other aspects related to Intellectual Property during an M&A transaction. Intellectual Property plays a crucial role in determining the value of a business and being such a high value aspect in a transaction, it is equally sensitive and prone to issues as well. To smoothly navigate through all the difficulties, the Intellectual Property of the target company needs to be duly analyzed and proper methods of transfer must be determined and adopted carefully. There are numerous legal aspects to this very specific area, such as the regulatory framework, tax implications, contractual aspects and other challenges and risks. Therefore, to ensure the success of the transaction and to leverage the Intellectual Property assets in the most effective way possible, all the legal fronts must be properly addressed. This should be meticulously carried out to ensure a storm-free sail and to eliminate the possibility of problems post-closing.

INTRODUCTION

In the current business-oriented environment, the flow of funds is the key factor to a business's success. If one can increase their inflow and make proper and effective use of their funds, that becomes one of the strongest foundational pillars for the venture to achieve heights. Since the inception of company laws, one of the key methods of investment and funding of a company is through share transfer transaction. For an investor, it is like buying an asset and holding it

until its value multiplies and gives him good returns for his initial investment. The asset he holds here is the part ownership of a company itself. From the company's perspective, it is like a sale where the investor buys a part of the company for a price, the consideration from which goes into the pocket of the company which in-turn makes the company's financials strong enough to carry out its venture effectively and give good returns to the investor. Mergers and Acquisitions are specific transactions, where in such transfer of shares, the buyer either buys majority of the shares, thus effecting the transfer of control and ownership of the company to the buyer (complete acquisition) or two companies merge together to form a completely new entity (merger) or the buyer only acquires a minor part of the company, i.e. less than 50% of the share of the company, as an investment or the like. In any of the above cases, the buyer needs to make himself aware of what he is getting into by conducting proper due diligence and compliance procedures. Assets of the company are a key aspect to investigate in such due diligence process.

Assets can be broadly classified into two: Tangible and Intangible. The difference between them lies in the fact that the tangible assets are those that can be physically felt in the real world, like land, machinery, buildings and money, and intangible assets are those that cannot be physically attributed in the real world, like Intellectual Property, goodwill and digital money, but its existence is still impactful. To put it simply, tangibles are physical assets, while intangibles are non-physical. In any kind of transaction discussed in the previous paragraph, assets are key to one's purchase. The present trend is that the intangibles contribute far more to the total value of a company¹. This is because the innovation and development of the globe has led to the adaptation of Intellectual Property rights, which forms a major part of the said intangible assets. Intellectual property rights are the exclusive rights to a creator relating to the creation made using his or her intellect. It is highly crucial for a company as they protect the innovation and creation of the company and give a competitive edge over the other market players. This advantage and protection have its own value which is also included in the valuation of the company.

When it comes to the commonplace of both above aspects, that is the way the intellectual property rights affect transactions of merger and acquisition, there are several legal fronts to be addressed. As earlier discussed, due diligence process before such a transaction is one of the key steps to a successful transaction. The process of conducting due diligence of the intellectual property rights and assets is not a easy task as it involves several loopholes and

precautions to be taken care of. This paper deals extensively about the process of conducting due diligence of Intellectual Property in an M&A transaction.

RESEARCH METHODOLOGY

STATEMENT OF RESEARCH PROBLEM

Lack of standardized due diligence process for Intellectual property rights in an Mergers and Acquisition transaction.

RESEARCH OBJECTIVE

The objective of the paper is to examine the risks arising due to absence of a standardized due diligence process of IP in an M&A and to provide steps to achieve a robust due diligence process.

RESEARCH QUESTIONS

1. What is the necessity for a standardized due diligence process for IP in an M&A?
2. What are the most effective steps of due diligence for IP in an M&A transaction?

SCOPE AND LIMITATION OF THE STUDY

The scope of this study focuses on analyzing the risks associated with the absence of a standardized due diligence process when dealing with intellectual property in a merger or an acquisition. The limitations of the study are the unavailability of literature reviews which are specific to due diligence of IPR in an M&A, which makes the paper almost as the first of its kind allowing the authors to recommend their own standardized due diligence process for a comprehensively complete M&A transaction.

RESEARCH METHOD

The research method opted for this paper is Doctrinal Research Methodology which involves studying various instances of failure in an M&A transaction. We have reviewed the arrangements in such transactions, the reason for the failure and the consequences to understand the effects of improper IPR Due Diligence in an M&A transaction, and suggested measures for a standardized process of Due Diligence.

ROLE OF IP IN M&A

Intellectual Property Rights play an important role in Mergers and Acquisitions as they are deeply involved in the development of the company. Intellectual Property constitutes the intangible assets of a company such as Patents, Trademarks, Copyrights, Industrial Designs and Trade Secrets. When a company is acquiring another company or merging with another company, the assets of the target company are transferred to the acquiring company or to the new company formed. The assets which are transferred include both tangible and intangible assets, where the intangible assets represent the brand value, technology or copyright works of the company which gives a competitive edge and is the main source of the company's asset portfolioⁱⁱ.

Patents are the inventions created by the company which may be the flagship product of the company such as new products, processes, compositions, computer programs and business systems. In the context of M&A transactions, patents hold significance value as they confer exclusivity over the product, manufacturing process, market and period of ownership for the invention. The Research and Development process and setting up of the manufacturing unit can be evaded with the acquiring of the patent rights as it is granted after undergoing the full procedure. By obtaining the patent rights, the transferee establishes market expansion and an enhancement to the existing product or extra business lines can be achieved.

Copyright acquisition gives the transferee exclusive rights to use, reproduce and distribute the works created. In the case of an IT company, software codes which is a copyrightable work gives the acquiring company operational advantage such as upgraded product offerings, new software solutions and streamlining processes, thereby elevating their position within the technology sector and satisfy customer requirements. For media and entertainment industries, the transfer of creative works such as the new age digital content which composes movies, television shows, music results in the ownership of the valuable assets. The control over the works enables the transferee to capitalize on various revenue streams which will ultimately give way to substantial profits by diverging into new market arenas.

Trademarks represent the brand value of the company, and the goods are sold under the name of the brand. They signify the company's reputation, trust of the consumer and market presence. The transferee gets access to different geographic regions, industry sectors and market expansion thereby enhancing their competitive position. The assets are in form of trademarks,

domain names, social media accounts and advertisements. The transferee obtains a leverage on the upon acquiring Trade secrets which are the secrets of a business covering the business strategies, formulas, algorithm or pattern which need not be disclosed to the public unlike patents.

Therefore, intellectual property such as copyrights, trademarks, patents, and trade secrets boost the company asset holdings as it elevates the value of the business and increases the profits for the business. A competitive edge can be achieved in the market by having a dominance on the other business and extend to different sectors by acquiring secret formulas and inventions thereby improving their quality of the product or service. Most importantly obtaining intellectual property rights in a merger and acquisition transaction leads to growth of the company and avid brand recognition and goodwill.

MODES OF TRANSFER OF IP

The transfer Intellectual property commences through an Assignment and License. When two companies merge and form a merged company or when a company acquires another company the transfer of intellectual property takes place to harmonize brand identities and integrate the intellectual property assets. Through this additional revenue can be generated from the new IP rights acquired through the transfer. The transfer may involve either the complete transfer of the ownership of the IP or by granting permission to use the IP without transferring the ownershipⁱⁱⁱ.

ASSIGNMENT AGREEMENT

Assignment is essentially the transfer of ownership which are the exclusive rights to a patented invention, registered trademark, copyrighted work from the assignor to the assignee which can either be a person or a legal entity. They are essential in merger, acquisitions and other transactions where the ownership rights need to align with the business goals and strategies. Assignment of copyright, trademark and patent rights require it to be in written and signed for it to be enforceable. The agreement should contain clauses which define the assignment of rights, scope of the assignment, consideration, the territorial scope, duration of the assignment, confidentiality and indemnity clause. Copyrights can be assigned either partially or fully considering the rights of the copyright owner. A registered or unregistered trademark can be assigned with or without goodwill of the company which is transferring the trademark. Assignment of the trademark with goodwill will assign the assignee with the rights and

entitlements associated with the trademark for the goods or services that the assignor is already using^{iv}. But with regards to assignment without business goodwill then the assignee will have the right only for the goods and services that the assignor is not already using under that trademark. Patents and trademarks not registered can also be assigned broadening the scope of IP transfer in business transactions^v.

LICENSING AGREEMENT

Licensing of IP, grants permission or authorization to a third party to use the IP without transferring the ownership under certain conditions such as monetary lump sums, royalties or a combination of both. It enables the entities which are acquiring the specific rights to monetize their assets, improve their market reach and control the usage of the IP. The components of the agreement specify the scope and limitation of the license, termination, consideration, and clarifies the extent of transfer. There are various types of licensing agreements such as Technology Licensing Agreements which allows the transferee to gain technology to enhance their existing product or develop new offerings, and a franchising or Merchandising Agreement which transfers the trade secrets that constitute confidential information such as the business model, brand standards.

WHY IS DUE DILIGENCE NECESSARY

While there are several benefits from the Intellectual Property Assets in a transaction, there are proportional risks and liabilities involved. It is the responsibility of the buyer to be cautious of what he is stepping into. There rises the need for due diligence of Intellectual Property Assets of the target company. For the buyer, the advantage from this transaction is the acquiring of the rights over the subject Intellectual Property, which might be of great assistance in his business or venture. For the target, the blood and sweat that he had put into developing of the innovation or developing the brand is handsomely rewarded financial benefit from the buyer. It hugely increases the value of a target company. However, to fully enjoy these advantages and benefits, the loopholes have to be plugged, and the potential liabilities need to be eliminated. This can only be done if the threats are identified in the first place. The identification of such threats can only be carried out effectively by having a robust due diligence process. For potential buyers, information concerning the strength of a target's IP assets helps to assess any risks associated with the seller's IP portfolio and may determine whether the transaction is worthwhile. Therefore, unless a due diligence is conducted effectively, companies may be exposed to

unknown risks and liabilities. For sellers, due diligence may improve the marketability of their company and allow them to identify weaknesses in their IP portfolio which might compromise a sale. The need for a comprehensive and robust due diligence process will be further cemented by the following example, where there was a huge consequence because of the failure or lack of proper due diligence.

The HP Autonomy Dispute^{vi}:

Autonomy was a UK company operating in the technology industry. The specialized in knowledge management and enterprise search. In the 2000s Autonomy has a shopping spree, acquiring several small as well as a few sizable companies. Subsequently in 2011, the company was acquired by Hewlett Packard as they buy 87.34% for a value of 5.44 billion euros. Autonomy developed a software which goes by the acronym IDOL standing for Intelligent Data Operating Layer, The software was developed using one of the systems from one of the companies that was acquired by Autonomy. In 2012, one of HP's senior members at Autonomy unit raised a concern regarding the accounting and economic practice at Autonomy. The analyst company Price Waterhouse Cooper was hired to conduct an internal investigation and audit to determine the errors in Autonomy's books. It was identified that Autonomy had sold low-end hardware at a loss and marked them as a licensing done for the IDOL software which had accounted up to 15% of the revenue derived from the licensing of the IDOL software. HP takes USD 8.8 billion as impairment charge of which about USD 5 million was covering accounting impropriety, misrepresentation and fraud. This triggered a string of litigations by the shareholders against HP and thus causing severe distress, not only within the company but also amongst the shareholders. In 2014, HP agrees to settle the shareholder lawsuits thus costing a hefty sum for HP. In turn, the shareholder plaintiffs agreed to assist HP in bringing claims against the persons who were responsible at Autonomy for the said malpractice. HP also agrees to strengthen its due diligence process for evaluating acquisitions. This could have been avoided if HP were diligent in the first place when evaluating Autonomy for their acquisition. The lack of proper IP due diligence from the side of HP has led to this huge mountain pile of litigation which could have been easily prevented by a comprehensive and robust IP due diligence.

PROCESS OF DUE DILIGENCE

The target of a due diligence before entering into a transaction is to ascertain as much risks and liabilities that a party is getting into by entering into this transaction and to afford for specific

protections during and after the closing of the transaction. An IP due diligence involves various processes and steps which are each equally important in their own way. It is employed not only in an M&A transaction, but also in other related transactions like JVs, Asset sales, security transactions among wide number of possibilities. For Buyers, information of the strength and profitability of the target's IP assets and the risks associated with such a portfolio, will help determine whether to enter such a transaction and in determining the practical and mutually agreeable value. On the contrary, unless an effective Due Diligence is conducted, the buyer may be exposed to undetermined risks and unforeseen liabilities.

Stages of Due Diligence:

1. Pre-Due Diligence Formalities:

Even before a due diligence process is done, a few preceding steps are to be taken, which helps protect both companies and the individuals involved in the middle. Both the buyer and the seller are exposed to each other, especially so when it comes to IP. Often, an M&A transaction has high levels of transparency. This is because the two companies involved in the transaction will commit to such a venture only after assessing each other's complete state, including the profitability, current financial health, prospective growth, scope of issues, etc. This is the process of due diligence. During such a process, it is almost unavoidable to not disclose at least a handful of company sensitive information or proprietary knowledge. This includes the disclosure of certain few aspects of the IPs that the company holds. For example, a pharmaceutical company's profitability and growth may be entirely based on a few patented drugs that they have developed. If an investment must be made in this company, or if the company is being acquired, the investor/acquirer will have to assess certain aspects of the patent in order to have the confidence in such an investment or acquisition. Thus, the disclosure of the IP is being done. To protect the knowledge from being applied or published elsewhere, the investor/acquirer must be made subject to an NDA which binds the party to not disclose any information that is being shared in this whole process.

2. Valuation of IP Assets

The next step is very critical which is to determine the value of the IP assets which are going to be transferred from the target company to estimate the value addition to the buyer company and the advantage gained due to the M&A transaction. The factors which are to be considered while studying the value of the IP assets of the

target company are firstly the sector in which the target company has its operation, secondly the market share of the target company which indicates that higher the market share, higher the value of the IP asset. Thirdly the financial status and the competition faced by the target company which indicates its position.

Methods of IP Valuation^{vii}

- a. Market-Based method- This approach is also called the transactional method which relies on comparing the target company's IP assets with similar assets that have been licensed or sold in the market under similar circumstances. It is a reliable method as it contributes to setting a fair price on the value of the IP assets and it can evaluate fair royalty rates
- b. Income method- This method indicates that the value is determined by the amount of income or profit the IP asset can generate. This is more of in a mathematical nature as it takes into to consideration the value of time to ascertain the value of the assets.
- c. Cost-Based method- This method has 2 approaches which is historic and futuristic. The historic approach includes the cost of procuring or producing the IP asset like the R&D, manufacturing cost and manpower cost to figure the cost of the IP asset which thereby equates to its value. The Futuristic approach depends on the ability to reproduce the creation or replace the creation in the market with another one.

The Jet Airways trademark case^{viii} highlights the importance of IP valuation in business transactions especially in mergers, acquisitions and IPOs. The Jet Airways company was founded by Naresh Goyal who initially registered the Jet Airways trademark in his personal name and not in the name of the company. Its IPO an issue was raised due the non-ownership of the Jet Airways trademark by the company leading to legal and operational issues. To solve the issue Jet Airways opted to purchase the trademark from Jet Enterprises which was owned by Naresh Goyal, thereby allowing Jet Airways to own the Jet Airways trademark. A license agreement was contracted between Jet Airways and Jet Enterprises allowing Jet Airways to use the trademark and a licensing fee to use it. The trademark was subsequently registered to ensure legal ownership and compliance especially for IPO process. The cost of acquiring and valuing the trademark was estimated at 7.5 million dollars showcasing the significance of IP in the overall financial worth of a

business. The company had to assess the value of the trademark to decide the terms of the acquisition and ensure that it aligned with the interests and goals of the business and investors. A proper IP valuation will ensure that the acquiring company knows what it is purchasing and how much value it will add upon obtaining the IP asset as in this case even though the value of the Jet Airways trademark was in million dollars it was necessary to acquire it to protect the brand identity, consumer interests and position in the market.

3. Register of IP:

To prevent confusion during the process, it is highly beneficial to have a register maintaining all the IP of the target company, of which the buyer may acquire all or only a certain few of them. Maintaining a register will give a clear picture to both the parties as to the contingencies related to IP in the said transaction ensuring that all relevant IP assets are identified, documented and the ownership, validity, enforceability and scope should be analyzed. The Apple-Proview case underscores the consequences of inadequacy in maintenance of a register for IP assets which contains details regarding the ownership and assignment rights of the iPad trademark and its scope. In this case Apple assumed that it had purchased the iPad trademark, but Proview argued that the division Apple dealt with did not have authority to assign the trademark in China which resulted in the removal of the iPads from the stores of China and Apple had to ultimately settle with Proview for USD60 million. Therefore, if Proview had maintained a clear IP register, it would have been easier for Apple to verify which division of Proview held the rights to the iPad trademark in China.

4. Determining ownership and valid registration:

One of the key steps in any due diligence process is to ascertain the person in control or the owner of the subject matter in hand. Be it a tangible or intangible asset, determining the owner and ownership is foremost step. Even in the case of IP, the importance of determining proper registration and applicant with respect to the IP is of major precedence. Establishing the ownership constitutes finding out the assignments, licenses given out and what all IPs have been sold or retained by the target company and what are the IP assets the target company owns without any encumbrance that can be transferred to the buying company hassle free. A small

case that happened in Germany can be a good example to why this step is very essential^{ix}.

In 1998, Volkswagen Group acquired Rolls Royce. However, one small mistake on the part of VW cost them dearly. Rolls Royce not only made cars but is also a manufacturer of jet engines and components. In fact, the company started out as so and only then expanded themselves into producing luxury cars, where they found immense success.

Volkswagen Group when acquiring the Rolls Royce car manufacturing business were negligent and missed a key detail. Though all the necessary IP for manufacturing the car was with the company they acquired, the trademark for the rolls Royce double-R logo vested with the jet engine company. Hence, even if the VW group had all of the necessities for manufacturing the car, they couldn't use it to market the car because of the lack of rights to use the logo for the brand. That specific IPR was purchased by BMW group which set up a company and further bought out Rolls Royce and thus became the new effective owner. Thus, determining the ownership and valid registration of an IP is of paramount importance in due diligence process.

5. Identifying litigation risks:

Like any other asset, even Intellectual Property can be subjected to litigation. It is important to determine whether the target IP under any litigation or any threat to litigation or if it has even a small exposure to a litigation process. If it has a existing litigation or threat to litigation, however lucrative the IP may seem, it is better to stay away from it as no one knows what is at the end of the litigation. one such example where litigation exposure led to one of the biggest M&A collapse is the previously discussed case of HP's dispute with Autonomy.

Had HP checked the licensing of the shareware IDOL properly, they could have avoided such huge losses resulting from the litigations from the shareholders and could have avoided the huge waste of cost, time and effort that they spend in suing the concerned persons at Autonomy.

6. Disclosure-confidentiality balance:

As earlier mentioned, in a process of Due Diligence, it is unavoidable to not disclose sensitive information to the other party. Two extremes to this are disclosure

and confidentiality. A perfect balance between those extremes is to be determined and struck to prevent post-closing collapse, or to prevent breach of confidentiality. It is key to define the scope of information disclosed and level of detail of such information. If the details that are to be revealed are fraudulently concealed, then that will also lead to litigation exposure as well.

An instance worth mentioning is the deal between Daiichi-Ranbaxy^x in 2008 wherein Daiichi purchased a 34.82% stake owned by Singh brothers in Ranbaxy for \$2.4 billion. The deal had been valued at \$4.6 billion. Shortly after, several issues had cropped up when the plants of Ranbaxy were inspected by the US Food and Drug Administration. A 2004 self-assessment report, that was not to be made public, indicated how the company had manipulated the data of which Malvinder Singh was also aware. Ranbaxy did not present the internal report nor its contents during the 2013 deal to Daiichi, showing malafide intentions. In 2013, Daiichi had filed an arbitration case against Ranbaxy in Singapore. The company had charged the Singh brothers of hiding and misleading facts that were relevant to the matter. If they knew about the self-assessment report, Daiichi said it would not have purchased shares in Ranbaxy. Former owners of Ranbaxy Laboratories Ltd must cough out \$385 million to Japanese pharmaceutical company Daiichi Sankyo Co., an arbitration tribunal in Singapore ruled yesterday. Ltd., which acquired the company in 2008, opines that information related to the transaction should be both timely and truthful during the M&A process. For one, "caveat emptor" cannot be a defense if there is proof of concealment or misrepresentation. Thus, the aggrieved party might be compensated.

CONCLUSION

In conclusion, conducting a thorough due diligence in an M&A transaction involving Intellectual property is essential to make sure that the tangible assets are obtained litigation free, properly valued and liability free. IPR are pivotal to a company's assets as they define value of the company and provide opportunity to derive revenue through licensing, assigning, and branding. They provide a competitive edge and market diversification to the acquiring company as it makes them stand out from their competitors for the rights in patents, copyrights and trademarks. To avoid future complications and encumbrances as highlighted in the case study discussed it is fundamental to go through the Due Diligence process by both the buyers

and seller to assess the value and risks associated with the acquisition.

RECOMMENDATION

It is important to Emphasize the necessity of due diligence of IP assets in an M&A for a smooth and seamless transaction which is convenient and profitable for both the parties. The stages of the process have outlined suggesting a streamlined procedure to transfer and obtain IP assets. The stages proposed are to abide the pre due diligence process, calculate the value of the IP asset to identify its true cost and how it will add value to the acquiring company, maintaining a register of the IP assets held, determining the ownership and identifying litigation risks and weaknesses. Other key considerations such as clear representations and warranties clauses regarding IP ownership and infringement which will protect against third party claims and examination of IP agreements to ensure comprehensive risk management. Ultimately a rigorous due diligence process is not only crucial for protecting the interests of both parties but also for ensuring a successful and smooth M&A transaction that fulfils the valuation of the IP assets.

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