

**ACQUIRING TECHNOLOGY ASSETS:  
INTELLECTUAL PROPERTY DUE DILIGENCE AUDITS**

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1. INTRODUCTION.

An intellectual property due diligence audit provides technology buyers and investors with a indispensable tool to make sound decisions regarding the value of a company's technology assets. As discussed below, an intellectual property due diligence audit examines a technology company's contractual relationships, knowledge base, discoveries, product names and other intangible property in order to evaluate and identify the extent of the company's proprietary interest in its technology assets. In short, the purpose and objective of an intellectual property due diligence audit is to determine (i) whether the company has adequately documented its contractual relationships and clearly delineated the scope of license grants, distribution rights, ownership assignments and other contractual rights and rights and obligations relating to the exploitation of the technology assets, (ii) whether the company's intellectual properties are adequately protected under one or more of areas of intellectual property law, and (iii) whether the company has infringed on any third party rights. At the conclusion of the intellectual property audit, the acquiring and/or selling parties should be in a position to confirm, validate, or disavow the integrity and value of the company's intellectual property rights in its technology assets.

2. SCOPE OF PROPRIETARY RIGHTS.

The following areas of law apply to the protection of intellectual property:

- a. Copyrights. Copyright law protects writings, audio-visual works and other forms of expression of an idea, without protecting the underlying idea itself. Copyright protection exists automatically when the work is created, but many works are nevertheless registered with the Federal Copyright Office (e.g., to preserve statutory damages and attorneys fees).
- b. Patents. Patent law confers the right on the patent owner to preclude others from making, using or selling the claimed invention in the country in which the patent is filed and issued. In the United States, patents are granted by the U.S. Patent and Trademark Office. While patents are much more difficult and expensive to obtain than copyrights, they provide a stronger and more comprehensive scope of protection (e.g., methods, processes).
- c. Trade Secrets. In general, trade secret laws protect almost information or technical data which is of commercial value and provides the owner with a competitive advantage. Trade secret protection is lost when the information becomes part of the "public domain" or generally known to the public. Accordingly, a company which fails to implement appropriate internal safeguards

and procedures to prevent disclosure of its proprietary information may lose or waive its trade secret protection.

- d. Trademarks. One of the most valuable assets of any technology company is the recognition of its trademarks and the goodwill associated with its trademarks. Trademark law protects names, words, phrases, and designs that designate the source of a product or service. A failure to protect a company's trademarks may result in the cancellation of a mark which has become "generic", or permit another to market "knock-off" products.

### 3. LEGAL DEVELOPMENTS.

Several legal developments have increased the need for and importance of intellectual property audits as part of the due diligence process:

- a. "Work For Hire" Doctrine. In *Community For Creative Non-Violence v. Reid*, The United States Supreme Court in 1989 significantly redefined the "work for hire" doctrine in copyright law. The effect of the Court's decision significantly narrowed the circumstances under which a hired work will be deemed to be a "work for hire" owned by the hiring or commissioning company. Given the Court's general application of general common law agency principles, most works created or produced by independent computer programmers and consultants will probably not fall within the Court's limited definition of "works made for hire". Accordingly, such independent contractors will own the copyright in such works unless such ownership rights are transferred to the company pursuant to written copyright assignment agreements. This complicates the due diligence process inasmuch as the acquiring company is necessarily required to delve deeply into a software products development history to surface any undisclosed ownership rights and potential claims.
- b. Software Patents. The U.S. Patent and Trademark Office has been granting patents for software-related inventions in record numbers. The availability of patents for software has required computer product companies to rethink their strategic approaches with respect to intellectual property rights (i.e., the appropriate mix of patent, trade secret and copyright right protection.) In early 1994, after an extended trial, Stac Electronics, a developer and publisher of data compression software, was granted a patent infringement award against industry leader Microsoft in excess of \$100 million.
- c. Copyright Protection For Non-literal Elements. During the late 1980s, federal courts dramatically expanded the scope of copyright protection available for computer-related works. Copyright may now cover, in addition to literal coding in a computer program, certain "nonliteral" elements such as the structure, the sequence and organization of a program and many aspects of its user interface and menu hierarchy. In particular, it has increased the potential risk of copyright infringement by technology companies developing "clone", "compatible" or

“work-alike” products. Recent decisions, however, have limited the expansion of the “look and feel” doctrine.

- d. Perfecting Security Interests in Copyrights. In the Peregrine case decided in 1990, a federal court changed the general practice for protecting security interests in a copyright. The court held that a security interest in a copyright may now only be perfected when it is recorded in the U.S. Copyright Office. The court concluded that the recordation provisions of the Copyright Act preempt the provisions of the Uniform Commercial Code with respect to the perfection of security interests in copyrights. Accordingly, mere filing of a UCC-1 financing statement with the local Secretary of State’s office does not perfect a security interest in a copyright or in its related accounts receivable.

#### 4. SCOPE OF THE AUDIT.

The appropriate scope of an intellectual property due diligence audit is determined by the type of technology assets involved and the value and nature of the particular transaction. A full scope audit covering all of a technology company’s intellectual property assets will typically be mandated for a buyer or investor contemplating an acquisition of a substantial ownership position.

#### 5. QUESTIONS TO BE ANSWERED.

The objective of any intellectual property due diligence audit would be to answer one or more of the following questions about a company’s technology assets:

- a. What was the origin of the technology asset?
- b. When was the technology asset first conceived and when was the development completed?
- c. Who are the people who could claim to be an inventor or author?
- d. What types of intellectual property rights might be available to protect the technology asset? Have those rights been protected?
- e. Has any employee, consultant, or other third party used any trade secrets or proprietary technology of others in the development, support, maintenance or enhancement of the technology asset?
- f. Does any third party have intellectual property rights that could be violated by past or future uses of the technology asset?
- g. Have any offers of licenses or assertions of proprietary rights infringement claims

been received?

- h. Where consultants or independent contractors have been used to develop the technology asset, have adequate measures and agreements been taken to protect the proprietary interests of the hiring party and to ensure that the hiring party owns the rights to the technology asset?
- i. If any portions of the technology asset were purchased or licensed from third parties, what rights were acquired by the technology company? Are there any obligations that, if breached, could result in a reversion of rights back to the third party?
- j. Have necessary federal and state registrations been made and transfers recorded with the appropriate agency?
- k. Has the technology asset been used to secure performance of any obligations?
- l. Do third parties hold any license rights, joint ownership rights or other rights in the technology asset?
- m. Is the technology asset substantially similar in function, appearance or coding to the technology asset of others?
- n. If proprietary materials and documentation of the company are held in escrow, what are the terms of the escrow arrangement (e.g., conditions for release).

## 6. THE AUDIT PLAN.

For most technology asset due diligence audits which envision a broad scope of investigation, a written audit plan should be prepared. The plan should define the areas of inquiry, the implementation schedule, who has responsibility for each area, and the form of expected report. The plan should also define the documents to be reviewed and the personnel to be interviewed. In every case, substantial information will need to be gathered

- a. Technology Demonstration and Overview. The auditors should be given a thorough demonstration of the technology and the products to be audited, including an overview of the history of the pertinent technology assets. The auditors should also be given relevant product brochures and advertisements.
- b. Document Gathering. A contact at the technology company should be assigned to coordinate the gathering of documents and information before the audit begins. Relevant documents may include: (i) license, maintenance and technology escrow agreements, (ii) OEM and distribution agreements, (iii) government contracts, (iv) federal registration and recordation documents (e.g. patents, copyrights and trademarks); (v) uniform commercial code filings and security agreements; (vi) employment agreements; (vii) consulting and product development agreements;

(viii) confidentiality and non-disclosure agreements; (ix) source code, object code and flow chart documentation; (x) clean room affidavits and other related documentation; (xi) materials referred to during the development process, (xii) competitive analysis documents; and (xiii) marketing files.

## 7. REMEDIAL ACTIONS.

The audit may reveal the need for remedial action to cure deficiencies in intellectual technology asset ownership and protection procedures. Examples include the following:

- a. Ownership Defects. Defects in intellectual property ownership may be discovered. Assignments of ownership should be obtained from parties holding ownership interests and recorded with the appropriate federal agencies.
- b. License and Other Contract Rights. The audit may reveal deficiencies in license rights obtained from third parties (e.g., grant does not include the right to sublicense, modify, or create derivative works). In the absence of sufficient license rights, the value of the company's technology asset may be severely diminished. Further, if the Company has granted third parties broad, vague or ambiguous distribution and/or bundling rights framed in poorly drafted agreements, these documents may have to be revised or rewritten to satisfy the purchaser.
- c. Joint Ownership. The audit may reveal third parties who may be able to claim joint ownership of the technology asset with the company. Joint owners are free to exploit the technology asset themselves without the permission of the company. Accordingly, the rights of the joint owner may need to be purchased by the company.
- d. Patents, Copyrights and Trademarks. Potential defects discovered in patents may need to be remedied by additional disclosures to the patent office, by a request for reexamination or reissue of a patent, or by amendments to pending applications. Errors in copyright registration may need to be corrected by filing supplementary copyright registrations. Errors in trademark applications and registrations may need to be similarly corrected.
- e. Infringement of Third Party Rights. If the audit reveals potential infringement of third party rights, the company should consider seeking a license from such third parties. Alternatively, the product at issue may be redesigned to avoid a patent or other proprietary right.
- f. Inadequate Filings. The audit may uncover areas of intellectual technology asset rights that have not been protected by appropriate federal and state filings. Such filings should be promptly made by the company to preserve its rights in the technology assets.