

IP asset due diligence in emerging economies: a primer

While emerging economies offer an attractive new market for the creation, investment and licensing of IP assets, transactions in such economies are complicated and the risk of loss or failure is high

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At present, virtually all business decision makers are aware of the opportunities for investment and business acquisition in countries considered to be “emerging economies” – typically thought of as the BRIC countries (Brazil, Russia, India and China), but also including numerous other developing countries in Africa, Asia and the Americas. Given their high rates of economic growth, increased access to capital markets and favourable consumptive and demographic trends, business asset investment and purchase (or licensing) in these countries has become a hallmark of the business strategies of increasing numbers of operating companies and financial investors.

However, unlike business investment and asset purchase transactions in more developed economies, such transactions in emerging economies are far more complicated, with a much higher potential for value loss or transaction failure. This is particularly true in the context of purchasing or licensing IP assets within emerging economies. Rapidly changing legal requirements, underdeveloped regulatory agency competence and differences in language and culture can make an otherwise simple IP asset transaction much more complex.

This chapter offers business decision makers with little or no experience in IP asset

transactions some practical tips and considerations when undertaking an IP asset transaction within an emerging economy. While it focuses primarily on discussing patent transactions, the tips and considerations discussed here may be applied to any asset purchase which involves “registered” IP assets (ie, patents, trademarks and copyrights).

The due diligence process in IP asset transactions

The purchase or licensing of IP assets, as for any other business asset, typically involves a due diligence inquiry: a process through which the assets to be purchased are verified to confirm that they are as represented by the seller and as expected by the purchaser. A complete IP asset due diligence process accomplishes three main functions for decision makers:

- The warranty function – the IP assets are what they are represented to be by the seller.
- The valuation function – the IP assets are worth what is being offered for their purchase.
- The relevance function – the IP assets are relevant to the business and other assets being acquired in the transaction.

Relative to other business assets, IP assets have a unique quality which is central to determining their ultimate value in a transaction – to a large degree, their value is determined by government regimes relating to IP asset ownership and allowance (eg, the granting of registered legal rights in the IP asset). Almost every country has a system for reviewing and granting rights to IP assets; however, within emerging economies, these

systems are often incomplete or underdeveloped compared to those found in more developed countries. As such, decision makers contemplating transactions involving IP assets in emerging countries would be wise to pay particular attention to reviewing ownership and allowance of the IP assets in question, with a particular eye on the governmental regimes under which ownership and allowance have been granted.

Ownership of IP assets in emerging economies: the warranty function

In an emerging economy environment, asset sale or licensing transactions involving 'traditional' assets – land, equipment and inventory, for example – are usually straightforward with respect to establishing clear title of ownership, as the laws and procedures covering 'traditional' property ownership are usually well settled and predictable. However, in regard to IP assets, the laws and procedures in emerging economies are less developed than those found in developed countries, due to a general historical emphasis in emerging economies on the development of 'hard'-asset businesses. This lack of emphasis extends into the operation of businesses and the mindset of business owners. As such, proper documentation of the ownership title to IP assets is often not undertaken by their owners in the first instance; moreover, the laws covering IP asset ownership in emerging economies are often incomplete or, at best, vague in application.

Of course, the threshold issue in determining IP asset ownership is whether a proper chain of title between the asset and the asserted owner can be documented. This may be a straightforward task if the asset is owned by a sole inventor, but is unquestionably more complex if the owner is an educational institution or an operating company. In regard to educational institutions, agreements by inventor-professors assigning the rights to their inventions to the institution are rarely executed; in addition, the institution's regulations regarding the ownership of IP assets developed by their faculty inventors may be vague or even non-existent, leaving the assets with no obvious legal owner. In the context of operating companies, while chain of

title may be simple to document, such documentation may not reflect whether the IP assets have been offered as collateral for financing (a common occurrence), or whether the assets have been licensed to another party. Complicating matters here is the fact that many emerging economies have little clear law on the proper recording and documenting of security interests or licences taken in IP assets. Given all of these circumstances, it would be wise to ensure that the due diligence enquiry related to IP assets includes interviews and requests for relevant documents from not only the seller of the asset, but also the asset inventor and the seller's financial and technical personnel, all of whom may possess information that relates to establishing precisely who owns the asset in question.

In addition, most registered IP rights involve a regular periodic payment to the government granting the right (referred to most commonly as 'annuity' or 'maintenance' payments). Failure by the asset owner to make these payments can result in the registered right being deemed abandoned by the granting agency, thus making the asset essentially worthless. Accordingly, enquiry into whether such payments have been paid on a timely basis is also essential in order to establish clear title in the assets. While verifying the status of such payments is a simple task in countries such as the United States (where a quick glance at the US Patent and Trademark Office website can provide current information), it is more complex in many emerging economies. Information may not be available online and, even if it is, it may be out of date.

Given all of these issues, a commonly asserted remedy is for the buyer to negotiate strong representations and warranties in the asset purchase agreement which require the seller virtually to guarantee ownership of the assets. However, the enforcement of such provisions in the courts of countries with less-developed laws and legal systems may be risky at best. As such, when purchasing or licensing IP assets in emerging economies, it is essential to undertake robust due diligence on IP asset ownership, preferably with a business or legal partner which understands the challenges of ownership verification in the asset's domicile.

Prosecution of IP assets in emerging economies: the valuation function

‘Prosecution’ is the term used by IP practitioners when referring to making a formal application to a government agency for the grant of a registered IP right, such as a patent or trademark. Prosecution typically involves the introduction of the asset, by appropriate application, to a government patent or trademark agency for review, with the ultimate goal of obtaining a final registered IP right. In the course of prosecution, the government agency will typically pose challenges (referred to as ‘office actions’) to the applicant as to whether the agency should grant the property right. Assuming that these challenges are overcome by the applicant, the sought-after patent, trademark or other IP right is then issued by the agency.

In developed countries, the prosecution process is highly developed, with reasonably clear rules for the prosecution and allowance of registered IP rights. Additionally, in developed countries the examination process for such rights (ie, the government review of the application to ensure that the right does not infringe on other previously existing registered rights) is generally robust, which provides greater assurance that the financial values assigned to such assets are more likely to be accurate.

Conversely, the practices and procedures of government patent and trademark agencies in emerging economies are far less robust. Prosecution procedures and application rules may be vague or change frequently, and the quality of examination may be far lower. In addition, as suggested above, the legal enforcement systems for IP asset rights in emerging economies typically leave much to be desired in terms of predictability and perceived fairness. Taken together, all of these factors tend to make the financial valuation of registered IP asset rights in emerging economies much more speculative.

Given these realities, decision makers involved in reviewing such IP assets for purchase or licensing must ensure that a thorough review is carried out to determine the ‘shape’ of the IP assets under consideration – there must be an enquiry as to the number of IP rights granted by the government agency, as well as an inventory of pending applications.

The office action history for each asset should be reviewed carefully to determine exactly what rights were granted (or under consideration) by the applicable government agency. Attention should be paid to whether the relevant agency has a history of or a reputation for allowing patents and trademarks (or other IP rights) to issue easily and rapidly – a potential sign that the allowed IP asset right may easily come into conflict with the rights of another party, which may indicate that the perceived value of the IP asset in question is overstated.

Technical review of IP assets in emerging economies: the relevance function

Finally, as a part of the due diligence process for IP assets, it is essential that a thorough technical review of the subject IP assets be undertaken in order to ensure that the assets are indeed relevant to the underlying rationale for the transaction at hand. In the context of transactions involving both the transfer of technical know-how and registered IP assets, it is not uncommon for the seller to assert (honestly or otherwise) that the registered IP assets included in the deal appropriately cover and secure the right to use the know-how. However, it is just as common for the IP assets to have little or even no technical relationship to the know-how being transferred. The registered IP assets themselves may still possess some intrinsic value as a standalone asset group, but as a part of the justification for a given transaction, may have no real assignable value.

Determining the relevance of registered IP assets to a transaction involves both technical and legal analysis. Technical expertise is called on first to understand the intended purposes of the transaction; armed with this understanding, subject matter experts then review the registered IP assets to see whether the assets are at least generally relevant to the transaction. This analysis continues until a specific technical link is found between the transaction and the registered IP assets. Legal expertise is then involved to review the claims and prosecution history of the registered IP assets carefully to ensure that the specific boundaries of what has been allowed in the registered IP assets do in fact ‘fit’ both the rationale for the transaction and the other

assets being transferred.

An additional consideration in the context of technical due diligence of IP assets from emerging economies relates to language differences. As most IP rights are registered on a national basis, the rights ultimately granted by government agencies are usually expressed in the predominant language of the country – for example, a Korean patent will be issued in Korean, a Chinese patent in Chinese and so on. While there are mechanisms to create analogous global rights in a particular IP asset, there is no guarantee that the language of the rights granted in one country will exactly match the language of those granted in another country. As such, there can be outcomes where mismatches in language create a situation where only partial rights to an IP asset are granted in one country versus another. On this point, it is also necessary to have experts who are versed in the language of each registered IP asset to review carefully and match the claims language in each IP asset to ensure some level of uniformity in the granted rights.

Comment

The purchase or licensing of IP rights arising from developed economies is a topic of growing interest for businesses embarking on expansion into these economies, and gaining IP assets in these economies can create important footholds for businesses hoping to expand into some of the most dynamic markets in the world. However, as with any business foray into a developing economy, decision makers would be wise to pay careful attention to the myriad of differences and challenges that accompany the undertaking of IP asset transactions in such economies. By bringing to bear appropriate legal, technical and financial expertise in the planning and review of IP asset transactions that are contemplated in an emerging economy, a business decision maker will be in a much better position to value and negotiate a transaction that serves the objectives of all interested parties. **iam**

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