



701:ABC's of Intellectual Property Due Diligence for M&A Transactions

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Faisal Shah

Faisal Shah is the founder and CEO of MarkMonitor, a leading provider of trademark and patent protection services on the Internet. MarkMonitor enables corporations and law firms to manage and monitor their online intellectual property by combining comprehensive domain name registration with brand protection solutions.

Prior to founding MarkMonitor, Mr. Shah was a partner with the Los Angeles office of Pillsbury Winthrop LLP (formerly Pillsbury Madison & Sutro, LLP) and later served as executive vice president and general counsel of Richardson Labs, Inc. At Richardson Labs, Mr. Shah handled numerous intellectual property issues and successfully represented the company before the Federal Trade Commission. He was also instrumental to the negotiation and eventual merger of Richardson Labs with Rexall Sundown, Inc.

Mr. Shah served as a member of the board of directors of the publicly traded company, California Beach Restaurants (Gladstones).

Mr. Shah holds a BA from the University of Colorado and a JD from the University of San Francisco School of Law.

Marc B. Victor, Esq.

Marc B. Victor is president of Litigation Risk Analysis, Inc., and the nation's leading expert in the application of decision-tree analysis to the determination of settlement value and litigation strategy. His consulting retentions have involved some of the nation's largest products liability, toxic waste, insurance coverage, breach of contract, patent infringement, antitrust, securities fraud, employment discrimination, and other suits.

Mr. Victor offers training in litigation risk analysis through a series of one- and two-day seminars. Over 10,000 senior legal decision-makers from corporate and government law departments, insurance claims staffs, and law firms have participated in these programs.

Mr. Victor, a member of the State Bar of California, is regularly a visiting professor at Tulane Law School. His most recent publication is "Evaluating Legal Risks and Costs with Decision Tree Analysis" from *Successful Partnering between Inside and Outside Counsel*. Mr. Victor graduated *summa cum laude* with a BA from Dartmouth College. He received his JD from Stanford Law School and his MBA from Stanford Graduate School of Business.

ABC's of Intellectual Property Due Diligence for M&A Transactions

Session 701
ACCA's 2003 Annual Meeting
"Charting a New Course"

San Francisco
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PANELISTS

- **Faisal Shah, Esq.**
Founder and Chairman, MarkMonitor, Inc.
- **Marc B. Victor, Esq.**
President, Litigation Risk Analysis, Inc.
- **Rose Deggendorf, Esq.**
*Managing Counsel, Mergers & Acquisitions,
Intel Corporation*

MODERATOR

- **Jennifer R. Pitarresi, Esq.**
IP Market Manager, LexisNexis

AGENDA

- **Review Hypothetical**
- **Purpose of Due Diligence**
- **3-Part Analysis of Hypothetical**
 - ▶ **Step A: Identification of IP Assets**
 - ▶ **Step B: Valuation of IP Assets and Risks**
 - ▶ **Step C: Protection of the Company**
 - **Due Diligence Checklist**
- **Questions**

HYPOTHETICAL – PAGE 1

Wallace Adman, Vice President of Strategic Marketing, and Leonard Liteswitch, Director of Development for Lucky Gaming Co., are meeting today with Lucky's Corporate Legal Due Diligence leadership team, led by Faisal Shah, General Counsel, Marc Victor, Director of IP Acquisitions and Rose Deggendorf, Chief IP Counsel. Lucky, which is headquartered in Carson City, Nevada, is a world leader in the design and development of microprocessor-based gaming and lottery products and software products.

The subject matter of the meeting is the potential acquisition of Yme Inc's electronic-gaming assets. Yme is a publicly held, manufacturing company, headquartered in Warren, Ohio. Some of the reasons Yme is selling the assets include:

- The gaming division was a disappointing venture in diversification for Yme, ever since its acquisition from Vegas Technologies (back in September of 1999). The initiative failed miserably. The gaming division group never really meshed with Yme's old-school corporate culture. An assimilation program was never implemented. Shortly after the acquisition, several of the gaming division employees (including a number of engineers and inventors) left to start another company. Since January, 2003, the division has discontinued product development and instead engaged only in maintenance updates for existing products.
- Yme is sorely in need of cash. The company is mired in a multi-billion dollar class action quagmire.
- Yme's stock-price has been hovering around \$2/share for the past six months (the stock peaked at \$47/share on August 2, 1999). Rumors of an impending bankruptcy are running rampant.

HYPOTHETICAL – PAGE 2

The gaming intellectual assets portfolio include:

- 10 U.S. patents (5 of which were acquired from Vegas Technologies); 10 pending US patent applications, and 5 invention disclosures
- 7 trademarks – 4 registrations have been obtained, an intent to use application has been filed, and two marks were previously acquired from Vegas Technologies
- Code for a handful of slots video games including "The Scooby Doo Craps Game".

Yme plans to make the acquisition of these assets contingent on the buyer hiring the 15 person engineering team (split between Nevada and India). This intact team is familiar with the needs of Yme's existing customers. Yme wants those customers to be happy with the sale since they buy substantial amounts of other Yme products that would not be the subject of this sale.

Both Messrs Adman and Liteswitch are pushing hard for the acquisition. According to Mr. Adman, this acquisition is a natural investment for Lucky. The patents cover a variety of slot machine technologies (all designed to enhance the machine's player appeal). Mr. Adman knows that Lucky's business is extremely competitive and that in order to remain on top Lucky needs new games that will set them apart from the rest of the field.

Mr. Liteswitch outlined the reasons he advocated the acquisition in an e-mail forwarded to Adman and the IP Due Diligence Team earlier in the week. Mr. Liteswitch stated that after carefully reviewing the patents, Lucky's game design team was extremely impressed.

HYPOTHETICAL – PAGE 3

The most noteworthy of the patents is U.S. Patent No. 5,722,871. This patent relates to slot machines and, in particular, to a variable award multiplier feature for a slot machine. The variable bonus multiplier provides an award multiplication factor that multiplies the award for a previous play.

Another intriguing aspect of the acquisition relates to a novel method for the use of bonus reels on a slot machine. This innovation has recently been added to several slot machine games, including Lucky's successful products "The Match Game" and "Poker Revival."

Mr. Liteswitch noted that many of Lucky's premium products currently in the design stage would use the slot machine technologies noted above to create a look and game-play experience never before seen in North America.

Mr. Adman also noted that apparently Yme had recently received a letter from arch-competitor and rival Rickerd Roulette alleging that Yme's new bonus reels on its recently released slot machines infringe Rickerd's US patent number 5,644,654, also relating to a method for use of bonus reels on slot machines. However, Yme assured Mr. Adman that this was a nuisance letter designed to intimidate Yme (who was already on the brink of closing the division) – Yme's in-house attorney had looked at the patent and had sent an email to senior Yme management assuring them that Yme's bonus reel technology was significantly different and did not infringe Rickerd's patent.

Messrs Liteswitch and Adman would like your support in convincing Lucky's Board of Directors that this acquisition is a good one (with limited risks). As the counsel for Lucky, how do you go about ensuring that the intellectual property portfolio underlying this transaction has in fact its purported value and is properly protected?

REVIEW: IP DUE DILIGENCE GOALS

- Information obtained through the due diligence process will help IP counsel to construct appropriate representations and warranties in the transaction agreements, but more importantly, it should be used as a basis to
 - ▶ correct title defects, where possible
 - ▶ adjust valuation, if necessary, and/or
 - ▶ allocate risks identified during due diligence, as appropriate.
- Title: Identify ownership or control issues
- Value: Determine the economic and strategic value of the IP assets to be acquired
 - ▶ Economic value is based on the type and scope of IP rights, and any geographic, time, or contractual restrictions
 - ▶ Strategic value depends on how well the IP assets support the acquiring companies business objectives and whether the IP rights can be effectively enforced against desired targets
- Risk: Evaluate liability risks associated with infringement of third party IP rights and protect company in transaction

STEP A: IDENTIFICATION

The Identification of IP Assets

Faisal Shah
Founder and Chairman
MARK MONITOR, INC.

IDENTIFICATION OF IP ISSUES THREE PART PROCESS

- **Setting Due Diligence Goals:** Counsel must set goals to gather information and assess the merits, issues and risks associated with the intellectual property assets to be acquired.
- **Understand the Transaction:** Counsel must understand the strategic business objectives of the client to meaningfully direct due diligence efforts to identify material issues and work to resolve them in a manner consistent with the client's business goals.
- **Performing an Independent Review:** Counsel must not only review information by the target but also conduct a thorough independent analysis as well.

IDENTIFICATION SETTING DUE DILIGENCE GOALS

- **Identification:**
 - ▶ Identify ownership or control issues
 - ▶ Identify liability risks associated with infringement of third party IP rights
 - ▶ Utilize independent information including online clearance tools
- **Valuation:** Includes determining the economic and strategic value of the IP assets to be acquired (for later discussion)
- **Protection:** Includes using information acquired during the due diligence stage to assist the company in constructing adequate reps and warranties in the transaction agreements (for later discussion)

IDENTIFICATION UNDERSTANDING THE TRANSACTION

- **Understand Objectives:** Identify the nature of the proposed transaction and the business and technical objectives of obtaining the relevant IP assets and their proposed post closing use.
- **Initial Requests:** Provide an appropriate set of initial due diligence requests to the target and review responses.
- **Follow-up Requests:** Provide appropriate follow-up due diligence requests to target to solicit answers to additional information.
- **Inventory:** Prepare an IP asset inventory summary and identify issues to be resolved prior to closing or otherwise to be addressed in the definitive agreements.

IDENTIFICATION CONDUCTING AN INDEPENDENT REVIEW

- The due diligence review should include both a detailed technical review and a legal review directed at obtaining information to answer the value/title/risk questions.
- Independent due diligence typically includes not only review of documents provided by the target, but also an independent assessment effort that may include searches of public databases, conducting interviews of corporate officers, in-house IP counsel, key inventors, engineers and marketing executives as well as conducting appropriate facility tours.

IDENTIFICATION – TECHNICAL REVIEW

Independent technical due diligence should, at minimum, include an analysis of the following elements and should be conducted by persons with both the appropriate technical expertise and an understanding of the business and IP issues surrounding the technology:

- Catalogue and analyze the targets, relevant patents, trade secrets and copyrights for ownership, coverage and limitations.
- Attempt to place the IP assets in the proper technical and market context, and evaluate IP assets against the seller's actual products, products in the pipeline, and marketing materials to determine scope and applicability.
- Evaluate competitive landscape, uniqueness of the technology, ease of incremental improvement, suitability of the technology to address customer needs and relationship to complementary technologies.
- Understand barriers to entry in the relevant field (e.g. IP rights of third parties, development costs, availability of expertise).
- Evaluate the technical competencies that are key to development of future products and related IP assets.
- Consider evaluating third party IP assets for clearance and enforcement purposes.

IDENTIFICATION – LEGAL REVIEW

- Legal due diligence is directed at answering the ownership/control and liability risk assessment questions identified above and also the more directed types of questions set forth below:
 - ▶ Has the seller adequately protected its intellectual property rights through patent applications or through some other means?
 - ▶ Has the seller entered into agreements that would give a third party a paramount claim of ownership to the core technology (e.g. consulting agreements with developers where the seller has not received an assignment of IP rights) or otherwise encumber the seller's ownership of the IP Rights relating to the core technology (e.g. exclusive licensing agreements and the like)?
 - ▶ Has the seller entered into appropriate agreements with its employees to ensure that the employees have an obligation to assign all rights in inventions and other IP rights to the seller?
 - ▶ Does the seller have knowledge of third party IP rights that would encumber the seller's freedom of action or ability to leverage its key technologies (e.g. pending lawsuits, notices of infringement, etc.)?
- Legal due diligence should be supervised by IP Counsel with assistance from the technical team.
- A sample checklist of the types of questions the legal team may seek to answer depending on the nature of the transaction, the business involved, and the type of IP assets being considered (not all questions will be appropriate in every transaction) is attached to this presentation.

STEP B: VALUATION

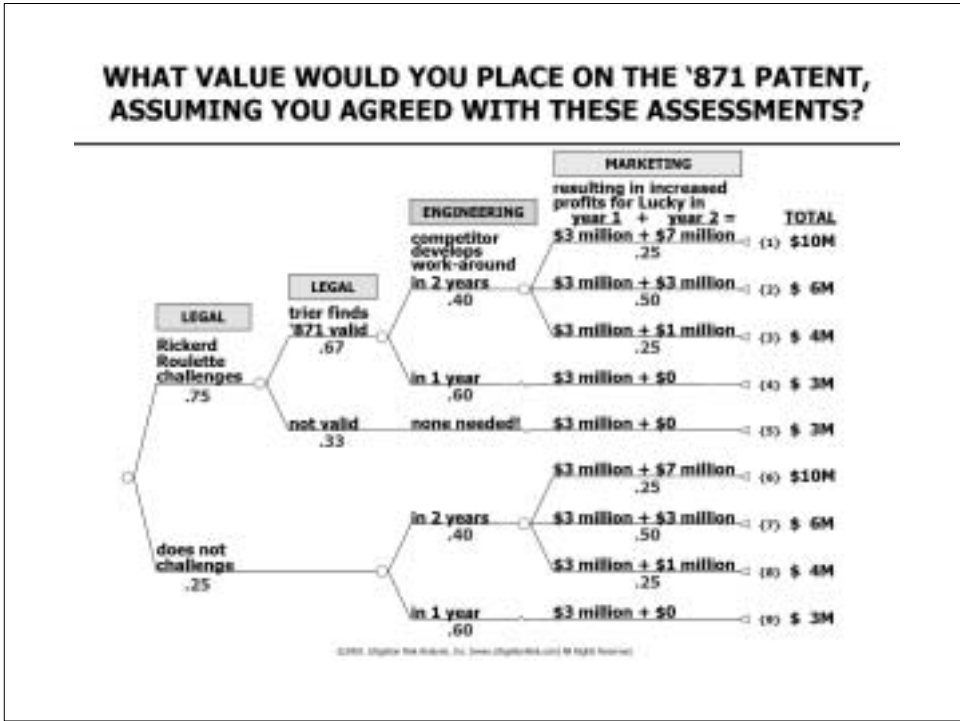
The Valuation of IP Assets and Risks, Using Decision Trees and Probabilities

Marc B. Victor, Esq.
President
LITIGATION RISK ANALYSIS, INC.

HOW CAN LUCKY GAMING BE SURE IT'S NOT PAYING TOO MUCH FOR YME'S "MOST NOTEWORTHY PATENT" — THE '871?

- The value of this patent depends on how long Lucky Gaming can maintain exclusivity of the invention, and thus generate increased sales and profits, compared to a future market in which the products of its major competitor, Rickerd Roulette, will also have this feature.
- That in turn depends on
 - (1) whether Rickerd Roulette challenges the validity of Yme's patent — and succeeds
and if not
 - (2) how long it would take Rickerd to engineer around the patent.
- The views of Lucky's legal, engineering, and marketing teams are expressed on the next slide.
 - ▶ *Note that in the worst case, Lucky feels it will have a 1 year advantage over Rickerd.*

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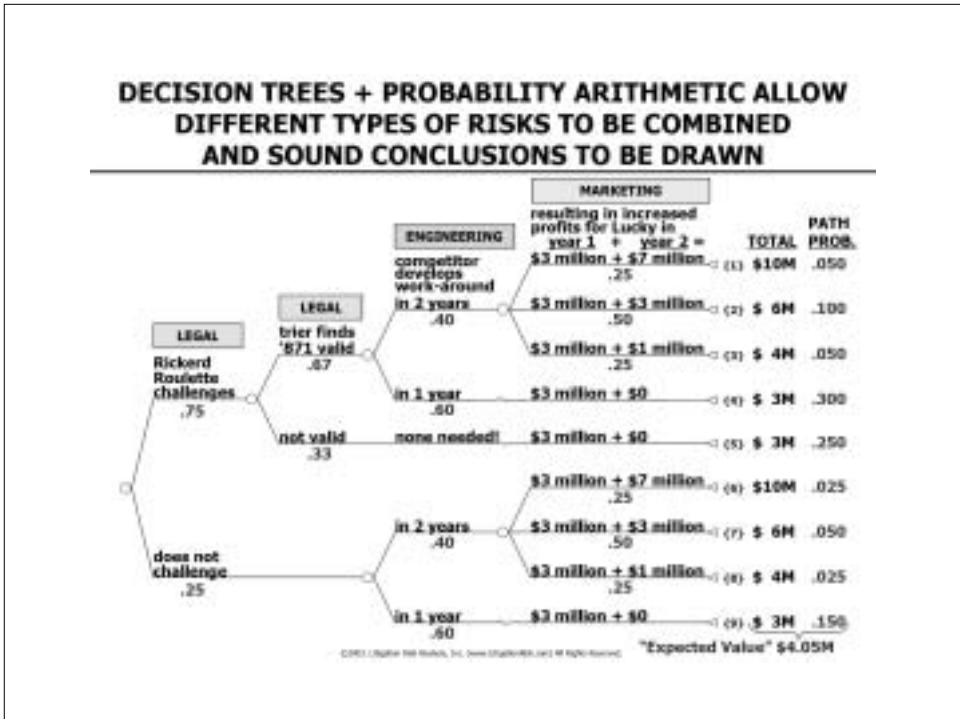


LAWYERS (AND OTHERS!) PREFER TO DESCRIBE UNCERTAINTY IN QUALITATIVE TERMS ...

	perhaps as low as		to perhaps as high as
• There is a good chance	_____ %		_____ %
• In all likelihood	_____ %		_____ %
• There is a definite possibility	_____ %		_____ %

▶ Indicate the range of probabilities you mean when you use each phrase, using numbers between 0 and 100 percent.

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**DECISION TREES + PROBABILITY ARITHMETIC
SHOULD ALSO BE USED TO VALUE
ACTUAL OR POTENTIAL LITIGATION**

- To prevent under-valuing a claim or potential claim and not seeking enough protection from the seller — either by negotiating a lower sales price for retaining the risk, or by seeking more indemnification.
- To prevent over-valuing a claim or potential claim, and unnecessarily walking away from a deal that would have been profitable even on the seller's terms.

For some examples of the application of decision tree analysis to the evaluation of litigation, see:

- ▶ Marc S. Victor,
"Risk Evaluation in Intellectual Property Litigation,"
INTELLECTUAL PROPERTY COUNSELING AND LITIGATION
(Matthew Bender & Company, 1998)
- ▶ Marc S. Victor,
"Evaluating Legal Risks and Costs with Decision Tree Analysis,"
SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL
(West Group & ACCA, 2000)

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STEP C: PROTECTION

Protection of the Company

**Rose M. Deggendorf, Esq.
Senior Attorney
INTEL CORPORATION**

Protection: Key Issues in Definitive Agreement

- **Representations and Warranties**
 - ▶ **Knowledge qualifier vs. risk allocation, precedents/policies**
- **Interim operating covenants in pre-Close period**
- **Closing conditions**
 - ▶ **Consent to assignment of certain key contracts**
 - ▶ **Any assignment of IP rights or other license cleanup**
 - ▶ **Conditions specific to the particular deal**
- **Indemnity**
 - ▶ **Overall indemnity, specific IP indemnity, or both**
- **Disclosure Schedules**
 - ▶ **Individual schedule vs. cross-reference approach**

Protection: Due diligence impact on Key Issues

- **Patent, copyright, trade secrets, and trademarks**
 - ▶ **Ownership, knowledge qualifiers on ownership**
 - ▶ **Ownership clouds**
 - ▶ **Infringement/misappropriation by target or third party, knowledge qualifiers**
 - ▶ **Threatened claims**
 - ▶ **Confidentiality issues**
 - ▶ **Use restrictions and residuals**
 - ▶ **IP contamination**
 - ▶ **Licenses back to target and enforcement &/or transfer issues**

Protection: Due diligence impact on Key Issues

- **Litigation**
 - ▶ **Pending, threatened, and settled approach and pitfalls**
 - ▶ **Coverage period, i.e. appropriate statute of limitations**
 - ▶ **Risk allocation for pre-Close claims whenever asserted and clear resolution mechanism**

Protection: Due diligence impact on Key Issues

- **IP or IP-related contracts**
 - ▶ **Price/risk impact of key contracts/licenses with competitors**
 - ▶ **Other risks that may impact Key Issues:**
 - **Non-compete provisions or contracts**
 - **Loss of patent licenses/cross-licenses or other IP licenses on change of control**
 - **Breadth of target's indemnities and allocation of any pre-Close risk**
 - **Exclusivity (type of IP and party issues)**
 - **Breadth of indemnity & likelihood of pre-Close claims post-Close**
 - **Termination of material contracts**
 - **Open source code or other consortia/special interest group agreements**
 - **Course of dealing or reliance issues**
- **Indemnity approach consistent w/the core issues/risks**

Protection: Overview of Key Terms and Caveat

- **Key Representations and Warranties**
 - ▶ **IP ownership, employee and consultant contracts**
 - ▶ **Material contracts & \$\$ thresholds**
 - ▶ **No material breach**
 - ▶ **No infringement**
 - ▶ **All that's necessary re: subject business**
 - ▶ **Necessary consents**
- **CAVEAT: Read Representations and Warranties and Schedules together carefully...**
 - ▶ **The Rep & Warranty's scope may differ from Schedule's scope**

Protection: Final points

- **Balance client's objectives vs. findings and what you are likely to get from the target**
- **It ISN'T negotiating if you are not willing to walk away**
- **The target will be part of your client's family soon...**

IP DUE DILIGENCE CHECKLIST

I. General Description of Company IP

- A. Provide a technical description of Company products and services, including formulations and manufacturing processes
- B. Describe how, when and where was the core technology developed

II. Patents

- A. List and provide copies of all foreign and domestic issued patents
 - 1. Copies of documents verifying ownership of patents
 - a. Copies of any patent assignments
 - b. USPTO documents confirming that any assignments have been properly recorded
 - c. Identify any joint owners of patent rights
 - 2. Describe whether any security interests or judgment liens have been recorded
 - 3. Copies of documents pertaining to any patent maintenance and foreign annuity payments
 - 4. Describe the Company's systems for paying maintenance fees and annuities in all countries
 - 5. Identify patents that are expired and/or no longer enforceable
 - 6. For key patents, copies of all prior art and prosecution history in Company files
- B. List and provide copies of all past and current foreign and domestic patent applications
 - 1. Provide documents verifying ownership of applications
 - 2. Describe whether any security interests or judgment liens have been recorded
 - 3. Describe status of pending applications
 - 4. List of all provisional patent filings and expiration date for filing application
 - 5. Copies of all Office Actions and Responses
 - 6. Copies of any clearance materials and non-infringement opinions evaluated prior to filing applications
 - 7. Identify any statutory bars to filing patent applications on active invention records
 - 8. Describe reasons for abandoning prior applications

- C. Identify Past, Current and Potential Patent Litigation
 - 1. Describe Company's enforcement policy regarding its patents
 - 2. Identify all known or suspected infringements of Company's patents and any actions taken
 - 3. Identify all third-party patents known to Company that relate to business
 - 4. Describe whether the Company has modified its technology to avoid infringement
 - 5. Describe any pending litigation in the industry which may affect Company
 - 6. Review all cease and desist letters, both sent and received
 - 7. Identify all license offers made to Company
- D. List and provide copies of all Patent Licenses (inbound and outbound)
 - 1. Identify any current or anticipated disputes
 - 2. Describe the results of any audits conducted by or against Company

III. Trademarks

- A. List all U.S., state and foreign trademarks and service marks registered to Company
 - 1. Copies of documents verifying ownership, such assignment documents or asset purchase agreements
 - 2. Copies of all registration documents
- B. Identify all pending trademark applications and all applications that were abandoned or rejected
 - 1. Copies of any clearance search reports for important marks
 - 2. Description of prosecution history and opposition proceedings for important marks
- C. List all unregistered marks and servicemarks, together with date of first use, and jurisdictions where such marks are used
- D. List of any assumed or fictitious names or other business names which Company has used during last five years. Provide copies of any associated filings.
- E. Copies of any Trademark Licenses (inbound and outbound)
- F. Copies of all quality control manuals, files or guidelines relating to goods or services sold under the marks
- G. Copies of specimens of marks
- H. Describe all past, current or potential litigation
 - 1. Copies of all cease and desist letters (both sent and received)
 - 2. Description of status of settlement, litigation or other resolution

IV. Copyrights and Computer Software

- A. Lists of all U.S. or foreign copyright registrations and date of registration
- B. Copies of all registrations
- C. Describe key works of authorship, including computer software. With each key work, identify:
 - (i) key works developed by Company
 - (ii) works that Company seeks to protect by registration
 - (iii) works to which Company has acquired rights to, either by assignment, license or otherwise
 - (iv) works to which Company has transferred rights thereto, either by assignment, license or otherwise
- D. Copies of all assignments, license agreements, options under which Company acquired any copyrights or under which the Company has the right to exercise any such rights belonging to any third party
- E. A list of all public domain materials incorporated in computer software
- F. A list of any third party materials incorporated in the computer software
- G. Identify past, current or potential litigation
 - 1. Copies of all cease and desist letters (both sent and received)
 - 2. Description of status of settlement, litigation or other resolution
- H. Copies of any escrow agreements pertaining to source code or other intellectual property of the Company or under which the Company has the rights to access third party intellectual Property

V. Domain Names

- A. List all domain names registered to Company for both gTLDs (.com, .net, .org and .info) and ccTLDs (international extensions such as .uk, .jp, .de)
- B. Identify whether any key trademarks are registered to third parties as gTLDs and ccTLDs
- C. List the expiration date of all domain names registered to Company and identify the registrar of record. Confirm that payment for such domain names is current.
- D. Determine whether Company has registered third party trademarks as domain names
- E. Identify all domain names registered to certain people associated with Company, such as the marketing director, CTO, legal department, IT department, or founder
- F. Review WHOIS information to verify ownership and to determine that registration has not expired
- G. Identify past, current or potential litigation involving Company domain names, including UDRP or other similar proceedings
 - 1. Copies of all cease and desist letters (both sent and received)
 - 2. Description of status of settlement, litigation or other resolution

VI. Trade Secrets

- A. Copies of all Agreements of the Company pertaining to any unpatented inventions, designs, styles, know-how or technical assistance whether owned by the Company or licensed by a third party to the Company
- B. List key trade secrets developed by Company employees
 - 1. List of all employees past and current and date of each agreement relating to confidentiality and assignment of works created during employment. If the form of agreement is not the same for each employee, provide copies of each non-standard agreement.
 - 2. Copies of all standard confidentiality agreements and assignment of works or non-compete agreements.
 - 3. Provide Company policies prohibiting disclosure of third party confidential information
 - 4. List of any employees that previously worked for a competitor of Company. Describe whether any employees may have brought materials or other IP from a prior employer and whether such employees were subject to any enforceable non-competes affecting their employment after termination of employment.
- C. List of trade secrets developed by independent contractors
 - 1. List of all independent contractors past and current and date of each agreement relating to confidentiality and assignment of works created during service. If the form of the agreement is not the same for each consultant, provide copies of each non-standard agreement.
 - 2. Copies of all standard Agreements relating to confidentiality, assignment, non-competition and non-solicitation
 - 3. Describe whether any consulting agreement include any licenses of pre-existing technology owned by consultant
- D. Describe whether any consultants or employees have claimed any rights against the Company for the technology they developed
- E. Identify past, current or potential litigation, relating to Company's trade secrets
 - 1. Copies of all cease and desist letters (both sent and received)
 - 2. Description of status of settlement, litigation or other resolution
- F. List of all non-disclosure agreements (NDAs) executed by Company and provide copies of any NDA's with competitors of Company or Buyer