Merger & Acquisition Focus

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Get smart about intellectual property

Intellectual property (IP) is a central, even defining, asset for many companies, and some M&A deals hinge on gaining access to IP assets such as patents, copyrights, trademarks and trade secrets. To ensure IP's value and boost their business' sale price, sellers need to be ready to demonstrate the company's legal rights to this intangible property. And buyers must perform careful due diligence so that they can be sure they'll get what they're paying for.

Sellers: Take stock

If you're planning to sell your company, there's no time like the present to begin preparing your IP for scrutiny. Start by identifying and cataloging all IP assets. You may need to work with both employees and outside consultants to uncover potential IP. For example, talk to employees who might be involved in creating proprietary information about IP that exists but hasn't been formally documented.

When cataloging IP inventory, many companies fail to thoroughly identify less discrete types of assets, including unpatented technology, trade secrets, trade dress (such as packaging design), databases, employee training manuals and other creative rights. A patent attorney can assist you in identifying procedures for cataloging IP.

Be sure to evaluate all intangibles that might count as IP, paying special attention to those with indefinite lifetimes. These values are reassessed every year, and if their market value falls below their book value, your buyer could incur impairments (or write-downs) that ultimately will affect their value and your selling price. To avoid these impairments, conduct a thorough and sweeping review of your IP assets before agreeing to the sale price.

Buyers: Leave no stone unturned

If you're buying a company, particularly if your acquisition is motivated by the target's IP, you need to make sure you leave no stone unturned during the due diligence process. Identify all of the key technologies, processes or products the target company has developed or uses. These may include:

Patents. Determine which patents have been issued to the company and which ones it has applied for. As part of your analysis, decide if the patents protect key technologies or only minor aspects of them. If the latter is true, competitors may be able to bypass certain patent protections. Find out too if any patent applications are provisional, if patent applications have been filed in all the countries where the company does business and if all are still in force. You'll also need to verify documentation proving that all patents' inventors have formally assigned the IP to the company — which can be tricky if the inventor has since left.

Copyrights. Companies working with independent contractors sometimes fail to ask them to sign agreements that release rights to IP, most commonly computer software. Unless your target has this kind of agreement, the work product legally belongs to the contractor, and you may have to pay a fee to use it.

Trade secrets. This class of IP includes formulas, practices, processes, designs, instruments, patterns or a combination of information used for competitive advantage. For trade secrets to be enforced in court, the information must be kept secret and made available only to those who require access to it. So determine if your target has employee or contractor secrecy agreements, nondisclosure agreements with potential customers or partners, and licenses with customers that restrict the use of proprietary information.

Licenses. A target's licenses can come in two forms: 1) those that give the company access to a third party's IP, and 2) out-licenses that the company issues to third parties. If your target licenses a third party's IP, the license should have favorable terms and not be in default or expiring soon. Also confirm that the issuing company provides the seller with timely updates on licensed information; isn't able to cancel the license without reasonable cause; and is willing to transfer the license to you as the new owner. And check to see if you'll owe royalties for the license's past or future use.

For out-licenses, be sure that your target's agreements aren't written so broadly (and include, for example, unlimited use by a large customer or exclusive arrangements with distributors) that it will be difficult for you to capitalize on them.

Anticipate snags

IP can be the cause of controversy between buyers and sellers during the due diligence and negotiation stages. A seller may, for example, argue that one of its registered patents is easily enforceable and, therefore, valuable. The buyer, however, may contend that the patent isn't very valuable because it was obtained based on only a small improvement to a particular technology — and one that isn't of much use to the buyer.

The potential for disagreements over IP value makes an independent appraisal essential — typically by a third-party appraiser mutually agreed upon by both parties. Although there are no standard formulas for valuing IP, valuators generally evaluate the market in which the asset is being used, project the income and revenue that the asset is likely to generate, and calculate a fair market value of the property by discounting the expected benefits by an appropriate rate of return.

How intellectual property is appraised can significantly affect the overall value of a company — and the M&A deal. So be sure you understand your valuator's rationale for using particular appraisal methods.

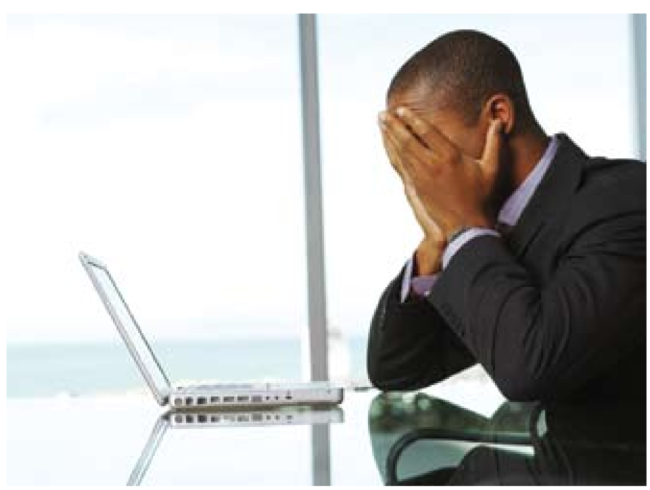
Realize value

Thorough IP preparation and due diligence won't guarantee that challenges and other surprises won't arise. But both are necessary if you hope to sell your company for a fair price or acquire the assets you intended to.

CROSS-BORDER M&As

Don't let people power become people problems

The number of international mergers is increasing as foreign companies target relatively cheap U.S. businesses. Nevertheless, plenty of U.S. companies are also crossing borders to expand their capabilities globally. Managing the legal, financial and operational details of any M&A can be arduous, and that's doubly true of foreign transactions. But among the greatest challenges you'll face are the "people" issues — including cultural differences and local labor laws and regulations.



Uncharted territory

Despite a flurry of activity on the global M&A front, success rates for these deals remain low. Poorly executed integration, productivity drop-offs and unachieved synergies are some of the culprits. But people problems are cited as a top concern among companies recently merged or acquired.

Employee issues specific to foreign acquisitions, such as coping with the new country's work conditions and staffing requirements and understanding how local customs and laws affect operations, typically arise in the postacquisition integration stage. Unfortunately, employee issues aren't as easy to plan for as many other business matters are. Acquisitions in developing countries, in particular, often are troubled by wide cultural gaps and miscommunications, and unstable local political and legal structures.

A diligent look

To help ensure you're properly considering employee issues, involve your HR staff at all stages of the deal. An HR representative should be included on the preclosing and postdeal integration teams. You may also want to consider hiring a culture consultant based in your target company's country to help you negotiate with the seller and help managers better communicate with and understand the customs of new employees.

Thorough due diligence also is essential. Be sure to conduct extensive background checks on selling owners and key staff, including searching for complaints and pending lawsuits from former employees. The vetting process also can uncover liabilities involving severance, disability, executive compensation and other issues that can significantly affect the profitability of a deal.

Other areas that merit planning and close scrutiny include:

Employee transfers. The structure of an M&A transaction typically determines if and how employees transfer from one entity to another. In the case of a stock sale, all company shares, assets and liabilities are transferred to the acquiring entity. With an asset sale, selected employees, contracts, equipment and other material assets transfer to the acquiring entity. Depending on the country of the seller, employee transfers require certain notices and severance considerations. So be sure that your attorneys and HR staff are familiar with these rules and are working with a consultant in the target company's country.

Unions and other employee representatives. In many countries, workers' councils, employee representatives and unions wield significant power over local companies. Failure to consult them about your acquisition plans could stall or even destroy your deal. So prepare for and comply with the consultation process of each individual group. In some jurisdictions, the meeting and negotiation process can take several months.

Noncompete agreements. In many M&A transactions, the parties negotiate noncompete agreements for key employees. Be aware that international jurisdictions have different restrictions. For example, in many countries, noncompetes are enforceable to the extent that they are sufficiently limited in time and scope. Be sure the noncompete provision you're negotiating is valid and enforceable, and consider the risk that a court

might award significant consideration to validate a noncompete that you may no longer wish to enforce.

Limitations on redundancies. At-will employment is virtually nonexistent beyond U.S. borders. Instead, most countries require not only notice and severance, but also cause to terminate an employment relationship. A redundancy caused by duplication of roles may not suffice as reasonable cause. Be sure you understand your obligations and rights and have negotiated whether you or the seller will make any terminations due to redundancy.

Immigration issues. Immigration-related issues can also cause significant legal liability and delay in cross-border deals. If you plan to bring acquired employees to the United States or send U.S. employees to work overseas, identify which ones have work permits or visas and determine how best to renew, transfer, terminate or otherwise handle these documents.

Benefits transfers. Maintaining the same or comparable employment terms and conditions and terminating, transferring or realigning policies and plans (both statutory and contractual) can cause a delay in the transfer of benefits. In many countries, the government provides benefits such as health and disability insurance. Get an early enough start on the benefits transfer process to ensure you understand your company's responsibilities and to avoid stranding employees without benefits for any period of time.

Most countries require not only notice and severance, but also cause to terminate an employee.

Retirement plans. Buyers should consider whether their company will merge the acquired company's retirement plan with their own or whether the seller will terminate the plan. If the selling company ceases to exist, it could result in an "orphan" situation in which the plan is no longer legally owned by anyone.

People possibilities

Acknowledging and understanding people issues probably won't eliminate all HR headaches. M&As, particularly cross-border M&As, are known for springing surprises. But by planning how you'll welcome aboard new employees, you can avoid many of the more common pitfalls. ■

A sprint *and* a marathon

HOW DUAL-PURPOSE INTEGRATION SUPPORTS SHORT- AND LONG-TERM GOALS

The challenge of merging two organizations isn't just to ensure that the new entity is ready to function as soon as the M&A transaction closes, but also to satisfy broader strategic objectives. Sometimes dealmakers focus too much on the first few months of integration and neglect to plan for the long-term success of the deal.

Parallel integration plans that are closely coordinated, yet have distinct purposes, help to immediately secure deal benefits as well as set the merged organization on the path leading to future success. It's important, therefore, to prepare separate 100-day and three-year plans.

The first 100 days

A deal's success — or failure — often is determined within the first 100 days after a transaction closes. A 100-day plan is intended to capture immediate gains, including cost-saving synergies and new growth opportunities. This period is typically when new information that didn't arise during the due diligence stage will be discovered, and undetected conflict over resources, work styles and employee roles, for example, is likely.

This postdeal period is also risky for customer relationships. Customers may have negative experiences relating to systems conversions, customer service and response quality, downsizing that eliminates their sales contacts, company relocation and inconsistent or changing policies.

To prevent a costly stumble right out of the gate, process integration needs to begin immediately. First, a clear vision and goals for the new company must be communicated effectively to both employees and customers. Ensuring that clients are adequately serviced and setting correct expectations will be critical during this phase.

Before the merger is complete, you must accomplish several tasks:

- Identify synergies.
- Perform a cash-flow analysis.
- Develop a restructuring plan.
- Develop a financial plan.
- Develop a communications plan.

The first step is to organize an integration team who will ensure that critical tasks are completed and milestones are reached. This team will be instrumental in creating a detailed integration program and managing the project. Tasks could include implementing cost reduction programs that advance synergy objectives, integrating cultural and organizational systems, communicating expected changes with employees, and monitoring the integration budget to control unnecessary expenses.

Also consider creating an integration scorecard to document milestones and evaluate accomplishments. Be sure to include clear targets, specific individuals to be accountable for achieving goals and regular monitoring procedures.

Three years and beyond

Your concurrently running long-term plan will focus on building a strong foundation and a sustainable revenue stream. Even though it's commonly called a three-year plan, it may take longer for the company to meet the plan's objectives. The complexity of your company's goals, difficulty you encounter when integrating different technologies and dissimilarity of the merging companies' cultures can all affect your timeline.

Your long-term plan should:

Build foundations. Identify the combined organization's strengths and competitive position in the current market and estimate them for future markets. Also pinpoint successes (such as high customer retention) and weaknesses (such as low employee retention) and the factors that contribute to them. This will help your management team make short-term decisions that may have long-term impacts.

Parallel integration plans that are closely coordinated, yet have distinct purposes, help to immediately secure deal benefits.

Coordinate internal efforts. Coordination among key groups and business units involved in the deal is essential to help establish uniform strategies for reporting, best practices and a shared understanding of the deal's overall strategic perspective. The resulting cohesiveness and team building will help drive the deal's momentum.

Focus on delicate issues. Don't neglect the sensitive aspects of the deal, such as those involving people. Organizational structure is important but meaningless if early decisions polarize the staff from management. Take advantage of the opportunity to create an organization where people are valued and are excited to work. Consistent communication about pending changes — both good and bad — is necessary upfront, but it's also important in laying the groundwork for the organization's future culture and work environment.

Using clear strategic metrics to assess customer loyalty and employee commitment, for example, are essential to ensure that the organization is focusing on the important issues — those that will produce value for the new company.

Twice the benefits

Focusing on both immediate and long-term integration plans can help uncover hidden blind spots and cultural baggage at the outset that potentially could derail your deal. It also enables you to assess the financial and organizational health and future capabilities of the new venture — and smooth out the integration process in between.

Ask the Advisor

Q. Does my private company need to comply with any SOX provisions?

A. The Sarbanes-Oxley Act of 2002 (SOX) ramped up government oversight of public companies and toughened penalties for corporate fraud and accounting abuse. SOX imposes a variety of disclosure and governance requirements, and though adherence is required only of public companies, many private companies can benefit from following SOX provisions — particularly if they expect their business to be acquired by a public company.

How does following SOX help?

SOX adherence makes your business more attractive to public companies, which can result in a higher sale price. Compliance with SOX can also improve your company's image and reputation with investors, lenders and the public by demonstrating that you have nothing to hide.

On the other hand, not following SOX provisions could reduce your pool of potential buyers. An acquirer may decide that ensuring your compliance isn't worth the time, expense and legal risk. Even if the public company does pursue the deal, you could receive less for your business than you had hoped.

What does the law stipulate?

Even though private companies aren't bound by SOX requirements, many of the law's provisions are considered "best practices" for corporate governance in the private sector too — particularly if your company has a number of outside investors. Key SOX regulations cover:

Personal liability. SOX mandates jail time for corporate executives who certify financial statements that are false or who destroy certain documents.

Financial controls. Management must have and be able to document a comprehensive system of internal accounting and financial-reporting controls.

Director independence. Depending on the diversity of your shareholder base, independent directors — individuals with no employment or business relationship with the company — are required to make up the majority of the board.

Auditor independence. Auditors now must be fully independent of the business they're auditing. And the definition of independence has become more restrictive. An auditor, for example, can't perform an audit for a company whose top managers worked for the auditing firm during the previous 12 months.

Personal loans. Companies may no longer engage in the formerly common practice of providing personal loans to its officers and directors.

What should you do now?

Full SOX compliance can be costly. But there are a number of measures you can easily and economically implement:

- Tighten your accounting procedures and internal controls that support financial reporting.
- Increase transparency in your reporting.
- Clarify or improve corporate governance procedures.
- Add outside independent directors to your board.
- Form an audit committee.
- Hire an accounting firm to review your procedures and controls and recommend improvements.

Your attorney and accountant can help guide you through the SOX compliance process. Even if you don't bring your business up to full adherence, improved internal controls and an enhanced image are likely to make your company more attractive should a public company buyer come knocking.