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IP IN THE CROSS HAIRS

Intellectual property (IP), and particularly computer software, is increasingly a top focus in making business decisions. A purchaser or licensee – the lessons are equally applicable in mergers and acquisitions practice as well as in the licensing of technology for in-house use or the contracting for outsourced technology services – can learn some valuable and very practical lessons from the experiences of a recent “busted” deal, a tough course in the school of hard knocks. Here’s part of the syllabus.

Due Diligence

Whether licensing software, contracting to outsource information services that rely upon specific software or acquiring software rights outright by purchase or through a business combination, the licensor, service provider or seller’s rights to the subject IP should be under the microscope and in the “cross hairs” of the acquirer’s due diligence process. Why?

Licensing

Most software licensing agreements have broad warranties – warranties that effectively guarantee that the licensor has the intellectual property rights necessary and appropriate to its making a grant of a valid and legally enforceable license and that the licensor will take action to ensure a licensee’s “quiet use and enjoyment” of the licensed technology. These warranties are often cloaked thusly:

Licensor represents and warrants that it can grant the license described in this agreement, that the license will not infringe on any United States letters patent, any trade secret or any copyright, trademark, service mark, trade name or similar proprietary right conferred by common law or by any law of the United States or any state thereof and that it has no knowledge of any existing adverse claim against its right to grant such license.

In guaranteeing the benefit of this representation and warranty, the licensor continues:

Licensor will indemnify, defend and hold harmless Licensee from any and all claims, actions, damages, liabilities, costs and expenses, including reasonable attorneys' fees and other costs,

arising out of a breach of any of Licensor's representations and warranties that a license will not infringe on the intellectual property of another.

Well, that takes care of it then, right? Maybe not. Money alone probably will not remedy the pain of having licensed and implemented an infringing product. And, damages are most likely limited such that the licensee bears the lion's share of the burden. Finally, there is counterparty credit risk; the licensor may not be financially able to pay whatever damages are assessed against it. (Not to mention the legal costs of a lawsuit to enforce the licensee's rights, whatever they may be.)

Now, consider typical options a licensor reserves to itself in the event of an infringement claim:

If an infringement claim has occurred or in Licensor's opinion is likely to occur, or if a Licensed Program is held to constitute an infringement and its use is or may be enjoined, Licensor may at its option and expense either replace or modify the Licensed Program so that it becomes non-infringing or procure for Licensee the right to continue using the Licensed Program. If using commercially reasonable means Licensor cannot provide either of these alternatives, Licensee agrees on written notice from Licensor to return or destroy, and certify in writing the destruction of, the original and all copies of the Licensed Program, and Licensor will refund to Licensee the license fee, prorated on a straight-line 5-year basis.

The expense, monetary and emotional, to adjust to new or modified software programs that do not infringe others' IP rights can be enormous. The licensor gets to choose whether to "pay off" a putative IP owner or to change the software. That change might be simply to modify the current program or more drastically to replace it or give you part of your money back and let you replace the software. In any event, none of the options is desirable to the licensee because of cost and business disruption.

Outsourcing

Is outsourcing better? After all, you are not "buying" software, just services. The service provider is obligated to provide services regardless of whether it has issues with ownership or licensing of the IP used to provide the services.

But, if the features and functionality of the services for which one has contracted are closely interwoven with end-user product delivery, the resulting problems from a vendor software change are not much different from those encountered by in-house users of licensed technology. Service providers, like technology licensors, almost always place both qualitative and quantitative limits on damages that an outsourcing company can recover from them.¹ When all is said and done, the customer experiences the greatest pain.²

¹ See *Damages for Data Security Breaches*, CARPENTER LAW OFFICE CLIENT NEWSLETTER (Robert H. Carpenter, Jr., Plano, Tex.), Oct. 2005, http://www.carpenterlaw.net/images/Damages_for_Data_Security_Breaches_Oct.2005_2007.pdf, for a discussion of the limits commonly included in outsourced data processing agreements.

² Consider this provision that was frequently used a few years ago by service providers:

We provide some services that may be included in this agreement using computer applications that are either proprietary or licensed from third parties. If any of them is (or will be within 12 months) no longer available or maintained in a manner acceptable to us, we may discontinue using it. In that event, we will provide you with an alternative processing application solution with functionality that is comparable to the discontinued application.

When customers realized the effect that a change in software pursuant to this language could inflict on them, they forced the industry to drop the term.

Mergers & Acquisitions

Acquiring software in a merger, stock purchase, asset purchase or other business combination can be no less daunting for the buyer. Model agreements do not have much to say about acquiring software. This is often as far as they go:

Seller has good title to and an absolute right to use [all know-how, trade secrets, confidential or proprietary information, customer lists, Software, technical information, data, process technology, plans, drawings and blue prints (collectively, "Trade Secrets")]. The Trade Secrets are not part of the public knowledge or literature and, to Seller's Knowledge, have not been used, divulged or appropriated either for the benefit of any Person (other than Seller) or to the detriment of Seller. No Trade Secret is subject to any adverse claim or has been challenged or threatened in any way or infringes any intellectual property right of any other Person.³

Of course, if one is acquiring in the deal title to software as an asset, the model agreement surely warrants good title.⁴ These protections are, however, thin reassurance when IP elements of a deal go bad. There is no warning, at least in advance, of actions that should be taken to prepare for acquisition or licensing of technology.⁵

Mergers and acquisitions produce contingencies that are analogous to licensing and outsourcing transactions. The "buyer" is at risk of losing the benefit of its bargain if the acquired software infringes on the protected IP rights of others.

Aim & Focus

An acquirer must evaluate targeted software on the cost/advantage and risk/reward axes, including in the analysis the size of and consideration involved in a particular transaction and how critical the acquired or licensed software is to the business plan,. Here are three of what could be many routes of investigation.

Provenance

Due diligence should begin with an investigation of the software code itself. If it was licensed from a third party, then one must look to the third party's practices to determine whether there are

³ AM. BAR ASS'N, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY (2001), §3.25(g)(iii) [hereinafter, MODEL APA]. Section 3.22 of the precursor model stock purchase agreement essentially says the same thing. *See* AM. BAR ASS'N, MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY (1995), §3.22(g)(iii) [hereinafter MODEL SPA]. The commentary to the MODEL SPA provision does caution:

In the case of software, the Buyer should determine whether the software is licensed to customers under a license agreement that defines the manner in which the customer may use the software, or whether the software is sold on an unrestricted basis.

MODEL SPA at 132. (The MODEL APA includes similar language in its commentary. *See* MODEL APA at 137.) Model merger agreements often mimic the approach to IP taken in the MODEL APA and MODEL SPA.

⁴ *See* MODEL APA §3.9 and MODEL SPA §3.6.

⁵ This is not even within the scope of many recognized treatises on mergers and acquisitions practice. *See generally*, AM. BAR ASS'N, THE M&A PROCESS, A PRACTICAL GUIDE FOR THE BUSINESS LAWYER (2005); Martin D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS, A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL, AND ACCOUNTING CONSIDERATIONS (2004); JAMES C. FREUND, ANATOMY OF A MERGER, STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS (1975).

ownership or development issues that must be resolved.⁶ In the case of proprietary software, the entire development process should be reviewed to ensure that, among other things, developers did not co-opt the code of others. Also, it is equally important to know whether and how open source code may have been incorporated into the programs under inspection.⁷

Sometimes a technical shakedown of source code is indicated. Software engineers can detect “footprints” in development comments and documentation that disclose ownership issues.

Personnel Practices

In reviewing the development plan for the source code, identify all employees and independent contractors who performed design or coding. And, depending upon risk tolerance, find out what every other employee, particularly in a small enterprise, actually did or does. (Sometimes the receptionist codes in a pinch.)

Determine whether all employees have contracts that include “work for hire” agreements and whether such employees have agreed to execute other necessary and appropriate assignments to ensure the enterprise’s ownership rights in their work. And, confirm that all independent contractors who performed design or coding work have contracts that confirm the enterprise’s ownership of their work.⁸

Outstanding Licenses

Finally, review outstanding software licenses (for both source and executable code). Confirm that these licenses contain provisions that protect the seller’s title to the IP that is being acquired. And, review code escrow agreements for similar exposure.

An acquirer or licensee should undertake an overall transaction evaluation before conducting due diligence on targeted software. Scope and intensity, along with capacity and tolerance for assumption of risk, will determine more precisely what and how that due diligence is conducted.

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⁶ Third-party software is often mature and time-tested. Infringement claims most likely would have arisen long ago, if they existed, or are barred by passage of time. But, if the licensor maintains it, new revisions include new code.

⁷ See *Secrets of the Code*, CARPENTER LAW OFFICE CLIENT NEWSLETTER (Robert H. Carpenter, Jr., Plano, Tex.), Apr. 2005, http://www.carpenterlaw.net/images/Secrets_of_the_Code_Apr.2005_2007.pdf, for further explanation of the effects of using certain open source code works in the development of proprietary applications.

⁸ If one or the other of these does not exist, determine whether such agreements can be obtained from present and former employees and independent contractors and evaluate the risks attendant to not having them.