

IP, Tax and Other Risks in Private Company Sales

By Henry Chen • Wood LLP

Practicing Law Institute recently held a perennial favorite, its seminar on Acquiring and Selling a Privately Held Company. It walked through all of the steps of an acquisition or sale, whether a large independent corporation, a division or subsidiary of a large public company, or a smaller venture capital funded enterprise. Within this landscape, specialty areas were presented concerning international issues and intellectual property.

Catharina Y. Min of Reed Smith LLP discussed intentional aspects. Joseph Yang from PatentEsque Law Group, LLP discussed intellectual property. Despite their different backgrounds, they discussed common principles that would be helpful reminders to any professional working on transactions.

Where Is the Value?

Both presentations covered comprehensive issues throughout the life of a deal. Mr. Yang and Ms. Min discussed the importance of identifying the underlying value of the target to efficiently manage the transaction. Value isn't necessarily about hard assets. It may be embedded in contract rights.

For example, in the international context, distribution and supplier agreements can be the lifeblood of the business. The acquirer will need to confirm that the rights can be transferred and identify the most certain method of doing so. That may start with the fundamental issue of identifying the owner of the rights.

What happens if it turns out that an employee owns the rights? If discovered early, the employee could be reasonably compensated to give consent to the acquisition. But the delicacy of this issue cannot be overstressed. Indeed, if the employee ownership (or, an

employee claim) is discovered late, just prior to closing, the costs can increase significantly.

Sometimes it is the buyer who says that the employee's authorization and sign-off is really needed. It can be maddening if the employee has left the target company and cannot be located. Indemnities alone may not be enough comfort in this kind of circumstance.

Indeed, if intellectual property is the crown jewel of the acquisition, Mr. Yang stressed the importance of identifying the key individuals who developed the IP. One wants those people in line if they are needed. Even if the individuals do not have any ownership claim on the IP, the IP can become stagnant. It may need to be developed or refined for the business to continue to succeed.

From the acquirer's perspective, it can also be important to identify the key individuals with the requisite talent to make sure that new IP is developed after the acquisition closes. Of course, identifying the key individuals who one expects to generate or modify IP can also be important for tax reasons in the international context. Sourcing rules in different countries may look to the location of the individuals that developed the IP.

Ms. Min also discussed countries that provide tax holidays if certain employment levels are met. These days, an international group must be increasingly sensitive to where IP is best situated to minimize its overall effective tax rates. In that sense, development in a particular place may be especially attractive. It might even avoid the cost and inherent risk of a sale or transfer pricing strategy.

Risks

By identifying what is most valuable in the target business, steps can be taken to guard

against that value not being realized or not living up to expectations. Often, this is done with representations and warranties, but the range of acceptable representations and warranties is surprisingly broad. What if a target represents and warrants that the valued IP does not violate a trade secret?

That might sound pretty good and is not limited by best knowledge or some other qualifier. Yet it might really only be warranting that the IP was not stolen. It can thus end up as a fairly weak representation, one that may cause the acquirer considerable heartburn.

A stronger representation may say that there has never been any infringement of the target's IP. Of course, making such a representation and warranty can be risky for the target if the representation is made without qualifiers. After all, there could be unknown infringements, and an absolute warranty is, well, absolute.

Reasonable qualifiers might say that the IP owner protected the IP within reasonable business practices. But buyers plopping down large amounts of cash for a business centered on IP may well insist on as close to absolute protections as they can get.

If you are thinking about bet-the-stakes issues like who owns the target's IP and how secure it is, you might well ignore an elephant in the room. It may not rise to the level of something that is common in every deal, but what about bribes? For international transactions, Ms. Min called out the Foreign Corrupt Practices Act (the FCPA) as a high-risk area of concern for clients.

There is no way to sugarcoat it, and bribing government officials remains extremely common in many countries. Local agents and employees of the parent or of foreign subsidiaries may be doing more than company officers know. And the potential liability can be criminal.

Due Diligence

With the fear of FCPA liability, Ms. Min discussed various practices that help to minimize FCPA risks. One is to follow the money. This should be done through not only the usual review of documents but also interviews with individuals.

And it is not just top lieutenants who can be expected to know. Sometimes it may be prudent to interview employees who are two

or three levels down the chain of command. Of course, documentary evidence is key.

In reviewing the documents, there should be coordination with a team. Local counsel is almost certainly needed, but local accountants and potentially even private investigators can be helpful too. A private investigator may be best suited for confirming the activities of key individuals.

Concerning IP diligence, Mr. Yang discussed how certain questions can help efficiently scope the work. One telling way to do so is to identify the IP that is needed to produce the top 10 percent of the business revenue. Another question to ask is whether any of the IP has been tested or challenged.

Another important area of concern is confidentiality privileges. Buyers may demand legal opinions concerning the targeted IP. Mr. Yang noted that the diligence process can often educate the target about itself and its own IP in ways the target has not considered.

The target may even want to review any legal opinions prepared for the benefit of the buyer. However, the acquirer should be careful not to disclose the opinion to the target directly in order to maintain its confidentiality privileges. If the acquirer wishes to work with the target on this point, the acquirer could request only outside counsel review the opinion on behalf of the target.

Structuring the Deal

Another common theme was the need to determine the structure of the transaction. The conventional options are an asset sale or a stock sale. Asset sales can be preferred to limit liability for the acquirer. Nevertheless, both Ms. Min and Mr. Yang discussed how an asset sale could be impeded due to restrictions on assignment of contract rights or IP.

A stock sale is a traditional answer to help minimize assignment restrictions. Still, there can be ways of having the best of both worlds. For example, Mr. Yang noted that reverse triangular mergers can be appropriate for this purpose.

Whether the transaction is implemented through an asset or stock sale, however, there can be additional international and IP complications. One is additional timing concerns. A subsidiary could be formed in the local country to make the acquisition.

It is easy to forget about the mechanics and the involvement of not always speedy foreign government offices. After all, forming a company anywhere in the United States can be done within mere hours. But the timing can vary significantly for other countries.

Moreover, local issues impact assets deals too. If the transaction is an asset purchase, the timing could take months. An asset acquisition of IP could require a separate registration subject to various local laws. According to Ms. Min, this could take months in China with registration in different provinces.

Living With the Deal

Both Ms. Min and Mr. Yang discussed the end goal: completing the transaction and making it work thereafter. To this end, careful enforcement provisions should be included, especially in the international context. The two parties may be from different countries, and disputes may best be resolved under pre-planned arbitration procedures.

Some common variables in the dispute-resolution provisions include a neutral governing law and a preset location to resolve

any disputes. The discovery process and the language to be used are also common negotiation points. Certain provisions may also be included for special issues.

Given their importance and variability, tax is often one such issue. An arbitrator, or group of arbitrators, could be selected from a group of tax professionals from a neutral location to be the arbitrator of certain tax issues. The idea is to set up protocols as the deal is being documented and long before any dispute arises so there is a reasonably level playing field when the time of any dispute does come.

For IP, Mr. Yang discussed the pivotal importance to the acquirer of making sure it *really* gets what it needs to continue with the business. He talked about identifying the valued IP and retaining and incentivizing the key individuals to continue to develop it. Inevitably, though, there must also be an allocation of risks in the representations and warranties to best protect the most important IP.

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