

How to successfully buy or sell a business with IP assets

Want to evaluate the IP of a business before you buy it? Want to sell a business at an increased price for its IP? Here is guidance on how to avoid the obstacles.

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Paul Kerin, Professor of Strategy at Melbourne Business School recently wrote that "hundreds of takeover studies have found that about 50% of takeovers destroy the acquirer's share value."¹

It is an appalling statistic but this high failure rate is unsurprising to professionals and insiders in the mergers and acquisitions game. To lift their game, what lessons can be learned by them and all buyers and sellers of businesses?

Clearly a buyer must be smart about all assets in a business before buying it. What does this mean for intellectual property (IP) assets in a business?

Being smart requires buyers and sellers to use legal and other professional advice at the earliest stage. This is the case for large corporates, SMEs and micro businesses. A central question is always - is the advice practical and really useful? How can a buyer or seller make this assessment?

What not to do is easily stated. If you are the buyer and you arrive in your lawyer's office to sign a contract to buy a business, and have had less than a couple of hours of prior enquiries, that is a sure sign that there are under-assessed or even unidentified risks buried in the detail. For example, the list of IP assets and many other points may lack clarity in the contract. So what procedure should you follow?

Three transaction stages

To steer you in the right direction for your next deal as a seller or buyer, structure enquiries into three stages which we will now consider in more detail:

- pre-contract stage,
- contract stage, and
- post-contract stage.

¹ Paul Kerin, Professor of Strategy at Melbourne Business School, "Doing what comes naturally" BRW (Business Review Weekly - www.brw.com.au), 27 January - 2 February 2005, p. 10.

While dealing with all asset types, let's focus on IP assets² in non-franchise businesses. IP assets raise many issues for buyers and sellers.

1A. Pre-contract stage - maximising the sale price for sellers

Prior to a business being marketed for sale, experienced lawyers inclined towards assisting sellers to maximise the sale price, can assist sellers in a number of ways.

In our firm we do a great deal of this sale price improvement work for seller clients. We also provide referral, training and coaching services for solicitors, accountants, business brokers and agents. Some business brokers provide good sale price improvement advice. Their work is in return for fees and/or a percentage of the sale price³.

Even where business brokers are involved, we find our service adds value to businesses founded on IP or tangentially incorporating IP rights in products or services. To improve results and productivity for clients, in providing the service we apply market knowledge and up-to-date expertise in specific areas of IP law.

After reviewing the seller's business, for a productive outcome we may suggest to a seller or its adviser to simply advertise or list the business for sale, avoiding unnecessary complexity.

² All businesses have IP assets as they all have goodwill or a name or brand. IP assets are limitless in their categorisation. They include software source codes, secret know-how, customer lists, IP rights in distribution and franchise agreements, domain names and lists of trade marks, copyrights and patents.

³ Pam Kershaw, "Seller beware", Sydney Morning Herald "Enterprise" section, 22 February 2005, p. 8 states: "The Australian Institute of Business Brokers says its members usually charge commission on a sliding scale, based on the sale price of the business. This ranges from 10 to 11 per cent on the first \$100,000 to about 4 per cent for a business worth several million. Corporate advisers charge about 4-5 per cent to 10 per cent for enterprises selling for less than \$10 million..."

Various professional services for sellers

If the business is not as simple as say a flower shop or café in a mall, the following extensive services may be recommended by us to the seller:

- preparation of a confidential "selling document", eg an information memorandum or disclosure statement or similar informational, marketing or profile document,
- preparing a data room or files categorising all key business documents,
- developing deal points to raise in negotiations,
- taking steps to improve perceptions regarding the value of specific assets, and
- comparing offers to determine which is best.

Why a "selling document"

In the absence of a vendor's statement or "selling document", money and time must be spent providing prospects with information on demand so as to attract and maintain their interest. In the right transaction this "supply on demand" approach can save costs.

However, in a more complex case the lack of a "selling document" can lead to higher risks of increased stress levels in negotiations, erosion of the buyer's trust, increased costs, legally actionable misrepresentations, and oversights due to haste. We have witnessed all of this. Early professional advice helps avoid or minimise these problems.

IP protection best practice

Protection of IP assets builds value for sellers. Before going to market, astute sellers build the quality and level of legal protection of IP assets, to at least what might be described as a base best practice level. (Ideally this work should be done at least 6 to 12 months before a sale.) Best practice includes use of up-to-date IP registrations and documentation. This affects copyright, trade mark, confidential information, design and patent assets.

Lower levels of protection can result in the buyer and its advisers discounting the price sought by the seller. For example, they may point to a low level or quality of IP monopoly. If so, our solution for a seller may be very effective, eg preparation of an intellectual capital register, business documentation, or registration of trade marks.

1B. Pre-contract - risk management for buyers

In business transfers buyers normally have much greater legal needs than sellers. Not surprisingly, in addition to their adviser's specialist advice, buyers appreciate commercial and practical opinions and advice. This challenges many professionals. Here's why.

Myopic professional silos

Assume for the exercise that legal advice deals with 10% of the issues in a target business, accounting deals with another 15%, leaving 75% of the issues to the buyer's managers, consultants, shareholders or other principals. This 75% seems an unfair share for them!

To reduce the load it can be more useful for a business (arguably especially if it is an SME) to receive advice that takes a holistic or integrated approach, rather than slavishly following the "legal", "accounting" or "management" labelling of issues. The former multi-disciplinary approach is not easy. To implement it, professionals must first build on

their foundational degrees in law, accounting or whatever. Few do.

For lawyers to follow the approach they must go beyond the dedicated area or "silo" of law and legal education and venture outside the scope of legal due diligence. Some don't wish to, some find this too difficult, and some find it unnecessary. Certainly, the multi-disciplinary approach is not always necessary, but where it suits our experience is it greatly reduces buyer failure rates.

Going beyond legal due diligence

Clearly, the buyer and its team of advisers should check or audit all issues and then logically group them as they affect both the target business and the future business. This is easier said than done.

In seeking to do this lawyers usually speak of "due diligence". However, the scope of "due diligence" in its US law origins and local practice by lawyers is in truth merely "legal due diligence". It is rarely comprehensive, holistic or integrated due diligence. It rarely ventures outside the silo of law.

CASE STUDY

The stats of a failed acquisition

What's wrong with this picture?

1. In 2000 Southcorp Ltd's had a slate of over 25 well-known wine brands included Penfolds, Lindemans, Wynns, Seppelt, Seaview, and Devil's Lair.
2. In early 2001 Southcorp paid A\$1.49 billion in a cash and shares deal for the single-branded Rosemont Estate business. The following year Southcorp posted a net loss of A\$923 million.
3. In early 2005 the Foster Group Ltd made a bid which valued all of Southcorp at A\$3.1 billion for the whole company.

Did Southcorp pay too much for Rosemont? Seems so.

The scope of legal due diligence by definition does not, for example, cover technology, cultural and organisational due diligence considerations (all are areas usually falling in the 75% share).

Sure, parts of the 75% can and often should be referred to specialist technologists, financiers or management consultants. However even if the work is outsourced to them, risks arise for a buyer if the jigsaw puzzle of miscellaneous advice then delivered is not pieced together by the buyer to test the "picture" of the target business.

Put simply - in a business sale or purchase transaction at some stage all issues forming the 10%, 15% and 75% must be logically grouped. Here are some reasons why:

- On the buyer's side, without proper grouping important considerations, signs and warnings regarding the target business or future business may be missed.
- On the advisory team side, it does not help if differences in the perspectives, jargon and procedures of lawyers, accountants and consultants create obstacles for communication outside their respective silo refuges (fortress walls?).
- If collectively (ie buyer + advisory team) the issues are not addressed, entire pieces of the picture puzzle may be missing at the time the buyer signs the contract for purchase.

Extrapolating on Professor Kerin's statistic, it seems reasonable to postulate that in about 50% of takeovers at the corporate level buyers sign with a blindfold on.

Given the appalling record of failure, rather than just apply mere legal due diligence, our view is that where appropriate it is preferable for sellers and buyers to implement the broad-based or multi-disciplinary process of risk management⁴.

Risk management properly implemented can broaden and deepen the scope of pre-contract enquiries. Being aware of the limits of law in the very important business sale and purchase area of work, to provide risk management services we introduce and collaborate closely with consultants in the advisory team. The aim is to collectively and rigorously apply risk management and integrate that process with such important process as:

- intellectual property auditing,
- asset evaluation,
- strategic planning,
- enterprise structuring, and

⁴ See AS/NZS 4360:2004 Risk Management, [SAI Global](#).

- knowledge management.

In this work we draw on our very large suite of tested legal and managerial templates for pre-contract risk management. They also help to efficiently produce reports for buyer clients. These pre-contact reports reduce risk and provide long term record keeping and decision making benefits for clients.

Applying rigorous project management

After initial enquiries are made we find sometimes buyers simply need short advice. This might be - "try before you make an offer, it looks too risky" or "seems like there is potential but the location is too difficult". At the next go/no go decision point our advice might be - "at this stage shape a possible deal with a heads of agreement or a memorandum of understanding, not a legally binding contract".

Rigour is built into this project management method of moving forward in defined deal making stages, and checking the seller's "story" at various points. One benefit is that it provides early warnings from any observed inconsistencies or unusual behaviour. If the seller seems too anxious to sell, it may be a sign of desperation, or a bargain for a buyer to swoop on.

"...where IP assets are involved, early, creative and disciplined "outside the box" legal thinking secures value."

To extend this a little further. Seller's must communicate their business opportunity, they talk, they want to sell. As we make enquiries for a buyer, the seller is obliged to deliver up evidence. If inadequate evidence signals that issues exist we warn clients to consider walking away.

There are many other ways of reducing the failure rate for buyers. If the target business is say a turnaround or recoverable basket case, then we might make, for example, three suggestions to the prospective buyer. First, compel the seller to first make needed changes at its cost. Second, offer an instalment payment arrangement. Third, seek the seller's personal guarantee or other security.

In closing on the pre-contract stage for both buyers and sellers, where IP assets are involved, early, creative and disciplined "outside the box" legal thinking secures value. Early enquiries deserve a great deal of emphasis - our experience and that of others⁵ is that a sale or purchase takes four to six months to finalise all tasks.

⁵ See Pam Kershaw, "Seller beware", Sydney Morning Herald "Enterprise" section, 22 Feb. 2005, p. 8 quoting Tim Miles, managing director, Miles Corporate Services.

2. Contract stage - transaction structuring and customisation

All business transfers require transaction structuring and contract customisation. This is where good lawyers can be particularly useful.

As regards just IP law considerations, for example, at the contract stage a lawyer may apply these **five structuring and customisation techniques** for a buyer or seller:

1. use of a confidential information agreement, or confidentiality provisions in a heads of agreement or memorandum of understanding;
2. review of consents and other considerations for moral rights and privacy law compliance;
3. tax and other revenue law implications of any apportionment in the contract of the sale price between the various assets being sold, eg apportioning values to specific brands, copyrights, patents or other IP;
4. warranties, indemnity, personal guarantees and other security arrangements given by the seller's directors or principals relevant to title and other risks to the IP assets; and
5. non-competition restraints on the seller and its principals, eg preventing hiring of former employees, starting a similar business or soliciting customers of the business.

In the typical hothouse, time-pressured and mission critical environment of business sale and purchase transactions, these considerations are among the many which require efficient treatment.

3. Post-contract stage - services for avoiding issues

Turning to the post-contract stage, our experience is that there are at least **six common failures** which cause problems with IP after a business is bought. The also affect franchises. Buyers should avoid these causes in the post-contract stage.

1. Failure to address IP issues properly or fully in the completed matter, with the issues coming back to bite after completion.
2. Failure to formally issue written assignment notices after completion regarding for example the assignment of a business sale agreement, an option, a guarantee for a debt, or a trade mark or patent.
3. Failure after completion to prepare updated and comprehensive IP registers, leading for example to missed deadlines, lost

- registrations and certificates, and wrong addresses on official registers.
4. Failure to act on gaps in IP protection, such as those evident from a pre or post purchase partial or full IP audit.
5. Failure to appoint appropriate IP specialists to deal with IP issues such as improving the template licence or terms of trade.
6. A general failure to employ best practices for IP protection, record keeping and general management after the purchase.

Failure 6 is often an outcome of a lack of alignment and integration between the businesses management, commercial, technological and legal processes and systems. This takes us full circle back to the need for pre-contract communication between different professional silos or disciplines.

4. Tools to work through the process – it's all about your peace of mind

Many IP considerations are treated more easily if there are available good template contracts and documents. In our firm we have invested substantially to develop these to help avoid issues in business sale and purchase matters and commercial transactions generally. They include:

- Template contracts, clause libraries, and management documents.
- Checklists, questionnaires, and instruction sheets specifically for business sale and purchase matters.
- Intellectual property auditing workbooks.
- Intellectual property register.

Call us to receive a set of these templates to prepare your next sale or purchase of a business. You'll avoid being a statistic for Professor Kerin.

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