6 Handling of Intellectual Property Rights in M&A

M&A (business reorganization) is an option for one company to buy the business of another company, with other company's patent and other intellectual property rights included, as a means to keep growing its own business while saving temporal cost. Japan has finished legislation of relevant laws such as Companies Act, and is entering the age of M&A. The purpose of this surveillance study is to research and analyze intellectual property related issues that are problematic in M&A to provide a baseline for discussing the handling of patent and other intellectual property rights in business reorganization. In this report, M&A transaction methods permitted in our country (Japan), the United States, and the United Kingdom are explained, first. Subsequently legal issues pertaining to the Industrial Property Rights Act and related acts, for instance, a reasonable remuneration pertaining to employee's inventions, treatment of license agreements etc. are gathered up by each M&A transaction method. In addition, issues and points of concern pertaining to M&A transaction and due diligence are analyzed. Furthermore the way of the valuation of intangible assets, accounting issues and tax treatments are mentioned. Finally the result of this surveillance study is analyzed with the cooperation of experts.

This research study was conducted, as part of the Japan Patent Office's research project on issues concerning the industrial property rights system, to study the treatment of patent rights and other issues in relation to business reorganization.

Ⅰ Business reorganization (M&A transactions)

In Japan, permitted methods of business reorganization include mergers, company splits, business transfers and acceptances, share acquisition methods such as share exchanges, share transfers and share assignments, and contributions in kind. When looking at business reorganizations from the viewpoint of intellectual assets, an important point is whether rights and duties are transferred from the extinct, split, or transferring company, to the surviving, succeeding, or accepting company, in a comprehensive manner as a result of the business reorganization. The intellectual assets mentioned above include not only intellectual property rights such as patent rights, trademark rights and copyrights, but also intellectual property such as brands, trade secrets and knowhow, as well as intellectual assets such as human organizations and organizational strength.

In the case of a merger, the rights and duties of the extinct company are succeeded by the surviving company in a comprehensive manner. In the case of a company split, the rights and duties described in the split agreement (or split program) are succeeded by the succeeding company in a comprehensive manner. In the case of a business transfer, the specified assets and liabilities are transferred from the transferring company to the accepting company individually. In the case of share acquisitions, such as share exchanges, rights and duties of the target company are not transferred to the buyer since there is no change to the juridical personality of the target company.

Outside Japan, in the United States, mergers, asset transfers and share transfers are permitted as methods of business reorganization. In the United Kingdom, in addition to asset transfers and share transfers, there is a procedure involving the court called the Scheme of Arrangement.

Ⅱ Legal issues and points of concern pertaining to the Industrial Property Rights Act and related acts

1 Issues pertaining to employee's inventions

Regarding business reorganizations in relation to employee's inventions, different problems are conceivable depending on whether or not patent rights and duties to pay a reasonable remuneration pertaining to employee's inventions will be transferred in a comprehensive manner as a result of the business reorganization, and to which company the patent rights, duties to pay a reasonable remuneration, and the inventor belong following the business reorganization.

In the case of a merger, patent rights and duties to pay a reasonable remuneration held by the extinct company are transferred to the

surviving company following the merger in a general succession, and the inventor is transferred to the surviving company. Here, the issues in relation to employee's inventions are, if sales increased as a result of the merger, whether the sales increase should be reflected in the profits to be obtained by the company, as well as issues pertaining to the unification of employee's invention rules.

In the case of a company split, the situation is more complicated compared to a merger, since the split company will survive following the business reorganization. Cases in which patent rights and duties to pay a reasonable remuneration are both succeeded by the succeeding company in a comprehensive manner can be considered in the same way as a merger. However, in cases where patent rights are transferred to the succeeding company and duties to pay a reasonable remuneration are retained by the split company, the patent rights and duties to pay a reasonable remuneration would belong to different actors, and the method of calculating the reasonable remuneration would become an issue. Additionally, in cases where the inventor is transferred to the succeeding company and duties to pay a reasonable remuneration are retained by the split company, or in cases where patent rights and duties to pay a reasonable remuneration are succeeded by the succeeding company and the inventor stays in the split company, duties to pay a reasonable remuneration and the inventor would belong to different companies. In these cases, the inventor would demand compensation to a company to which s/he does not belong, and the method of calculating the reasonable remuneration would become a problem. In addition, with regard to employee's invention rules, when the split or succeeding company newly establishes or revises employee's invention rules, it is necessary to establish a method of calculating the remuneration value with the assumption of cases where patent rights, duties to pay a reasonable remuneration and the inventor are owned by or belong to different companies. Furthermore, in the case of a company split, there is also the issue pertaining to creditor protection procedures; specifically, whether the inventor qualifies as a known creditor.

In the case of a business transfer, rights and duties are transferred in a specified succession. It should be noted that the consent of the inventor is required if duties to pay a reasonable remuneration are to be transferred to the accepting company.

2 Issues pertaining to license agreements

In the cases of mergers and company splits, the statuses of licensor and licensee in a license agreement are transferred to the surviving or succeeding company in a comprehensive manner. Therefore, there are no problems regarding the ownership of the statuses of licensor and licensee in a license agreement. There is a problem, however, if the license agreement contains a special provision that bans business reorganizations (provision banning mergers, etc.) or a COC (Change of Control) provision. Furthermore, in cases where, at the time when the license agreement was concluded, it was not envisaged that the licensee or licensor would become party to business reorganization, a provision banning mergers, etc. or a COC provision are often not provided. In such cases, there is a possibility that the counterparty of the license agreement might incur unexpected disadvantages, which would become an issue.

If the licensee conducted a company split, there would be cases where both the split company and the succeeding company would require licenses, which would pose a problem.

Furthermore, if the license agreement is a comprehensive license agreement, the patent rights subject to the license are not specified by patent number, etc. Then, if the licensor side underwent business reorganization, would that signify an expansion of the patent rights subject to the comprehensive license agreement?

Regarding business transfers, there are two problems. The first problem is, in cases where the licensee undergoes a business transfer, whether the status of holder of non-exclusive registered right to work is transferred with the business, pursuant to the provision of Patent Act Article 94, paragraph 1. The second problem is, in cases where the licensor transfers patent rights in line with a business transfer, whether unregistered holders of non-exclusive registered right to work can counter the new patentee.

3 Points of concern regarding M&A transactions

In M&A transaction agreements, in order to move the deal to the next step, provisions such as representation and warranty, pledge, compensation and condition precedent are provided for issues that could not be uncovered

by due diligence, or were uncovered but could not be resolved, due to restrictions with respect to the time and personnel spent on due diligence. Notably, the role of the representation and warranty provision is important as it specifies the patent rights owned by the target company and represents and warrants that the rights are registered, etc. However, it should be noted that the party making the representation and warranty would bear a significant risk if it made excessive representation and warranty, such as "no infringement on a third party's patent rights."

In addition, in M&A transaction agreements, security provisions are commonly taken in order to secure payment of damages or compensation in case one of the parties breaches an agreement. These provisions include a two-stage payment method, compensation by the parent company upon representation and warranty, and using escrow accounts.

4 Points of concern regarding due diligence

Due diligence is conducted in order to find risks in an M&A transaction. Due diligence specifies and confirms intellectual property rights owned by the target company, examines the agreements concluded by the target company, confirms the validity of rights and grasps contingent liabilities such as risks regarding infringements of intellectual property rights of third parties and risks regarding employee's inventions.

In confirming agreements, license agreements and joint development agreements are mainly evaluated, focusing on whether a so-called COC provision exists and, if it does, on its content. The judgment of the risks of infringing intellectual property rights of third parties is extremely important from the standpoint of business continuity following the M&A transaction. However, as this requires high-level and specialized knowledge, and is difficult to judge in a short period, due diligence in reality is conducted only with the minimum necessary examination and judgment is avoided through representation and warranty, pledge, etc.

In some cases of due diligence, the target company discloses confidential information to the buyer. The method of confidential information disclosure and the treatment of disclosed confidential information require particular care and attention.

Ⅲ Issues and points of concern regarding value, valuation, accounting and tax

1 Value and valuation

In M&A transactions, the value of the target enterprise (or business) is appraised in order to decide the purchase price. Usually, when appraising the target enterprise (or business), it is rare to appraise separately the intangible assets owned by the target enterprise (or business) concerned. However, in cases where the purpose of the M&A transaction lies in acquiring intangible assets, or where the transaction involves buying a research and development-oriented enterprise, it becomes necessary to appraise the industrial property rights, technologies, trade secrets, knowhow, human assets, etc. of the enterprise concerned. Since valuation for deciding the purchase price is different from valuation for accounting purposes, it is meaningless to allocate value to individual intangible assets. The subject of valuation is to be decided depending on the purpose of the M&A transaction.

There are several ways of appraising intangible assets, which are classified into a cost approach, market approach or income approach. Each has its advantages and disadvantages. The optimal method should be chosen in light of the purpose of the M&A transaction. The income approach calculates the enterprise value and value of intangible assets based on the future profit to be generated by the enterprise. Since the purpose of M&A transactions lies in improving the enterprise value, it is desirable to appraise intangible assets using the income approach.

2 Possibility of leaks of technology, etc.

In M&A transactions, confidential information of the target enterprise is disclosed to the buyer for purposes such as deciding the purchase price. However, M&A transactions are not always successful. In cases where the deal is cancelled halfway through, the target enterprise would end up having disclosed confidential information to a third party without gaining anything from it, resulting in a substantial loss.

Additionally, given that the higher the confidentiality of the information, the greater its impact on the purchase price, the enterprise disclosing information is typically caught in a dilemma between the purchase price and

maintaining confidentiality. While there is no absolute measure to prevent leaks of confidential information, one possible way is to limit the disclosure to a third-party valuation body.

3 Accounting valuations and reporting methods of patent rights, etc.

In Japan, accounting standards pertaining to business combinations have been established and are in operation. Under the accounting standards, accounting procedures for business combinations, in principle, use the purchase method, while the application of the pooling of interest method is permitted as an exception. Accounting procedures using the purchase method involve goodwill, which is amortized over a period of up to 20 years. In addition, patent rights etc. acquired in M&A transactions can be treated and reported as intangible assets. However, since the accounting standards merely approve of reporting them as assets, it is rare for patent rights etc. obtained in M&A transactions to be actually reported as assets. In cases where in-process research and development have been acquired, research and development expenses are to be reported as costs.

The business combination accounting standards were revised in December 2008 and new accounting standards will be applied to business combinations starting from April 1, 2010. Under the new accounting standards, accounting procedures using the pooling of interest method will be banned in business combinations. In addition, in cases where the purpose of the M&A transaction lies in acquiring intangible assets, the intangible assets in question are required to be reported as assets on the condition that their value can be measured accurately. Research and development expenses for in-process research and development acquired in M&A transactions are also required to be reported as assets if they meet certain conditions. Under the revised accounting standards, an enterprise's intangible assets that are expected to become a future profit-making source will become reflected in financial statements more than ever.

In the United States, SFAS 141 provides for accounting procedures for business combinations and SFAS 142 provides for the treatment of intangible assets. Accounting procedures for business combinations are to use the purchase method (the pooling of interest method is banned), and reporting intangible assets is compulsory if certain conditions are met. In-process research and development expenses need to be reported as costs. Goodwill is not amortized but, instead, is subject to impairment tests each term and reported as a loss if impairment has been confirmed.

In the United Kingdom, listed enterprises are required to conduct accounting procedures in accordance with IFRS (International Financial Reporting Standards). Under IFRS 3 and IAS 32, accounting procedures for business combinations are to follow the purchase method (the pooling of interest method is banned), and reporting intangible assets is compulsory if certain conditions are met. If in-process research and development have been acquired, development costs that meet the requirements set by IFRS are required to be reported as assets.

As explained above, accounting procedures for business combinations differ by country. However, given that investment activities are transcending borders, Japanese and U.S. accounting standards are increasingly converging with IFRS, and a direct adoption of IFRS is also under consideration. The aforementioned revision of Japan's business combination accounting standards took place amid the current trend of accounting standard convergence.

4 Tax treatment

When business reorganization is conducted by means of a merger, company split, share exchange, share transfer, etc., an organizational restructuring tax system is applied. If the business reorganization is recognized as a qualified organizational restructuring, a rescheduling of asset transfer gains or losses is allowed and taxation does not take place. On the other hand, if it is recognized as a non-qualified organizational restructuring, asset transfer gains or losses are subject to taxation. Since intangible assets are often unreported, if the business reorganization is recognized as a non-qualified organizational restructuring, the value of the transferred intangible assets must be appraised and taxes must be paid. There are no provisions in the Corporation Tax Act regarding the valuation method of intangible assets. For practical purposes, intangible assets are appraised by making calculations based on basic instructions for property valuation used when calculating inheritance tax and transfer tax, or in accordance with the excess profits act.

Ⅳ Analysis of research results

Based on the outcomes of domestic and foreign literature research, overseas research and domestic interview research, legal and other issues regarding the treatment of patent rights etc. in relation to business reorganization were brought together and analyzed with the cooperation of experts.

Regarding the legal issues pertaining to the Industrial Property Rights Act and related acts, two attorneys analyze and discuss the topics of "problems arising in each stage of an M&A transaction and practical responses" and "problems with intellectual property laws in relation to M&A transactions that need be resolved" from the standpoints of practitioner and legal expert.

With respect to issues and points of concern regarding value, valuation, accounting and tax, a certified public accountant analyzes and discusses, based on his business experience, the following five issues: (i) Valuation method selection, (ii) Computational elements of the discounted cash flow (DCF) method, (iii) Valuation result discounting, (iv) Brand value appraisal, and (v) Effect of differences in accounting and taxation procedures.

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