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Intellectual Property Issues in the Sale of Your Business

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Selling a business can be joyful, stressful, painful, or just plain bothersome to a business owner – it just depends on the circumstances. Selling a business that has "hidden" intellectual property can cause unexpected headaches, but it doesn't have to.

When preparing to sell, many business owners think that their business doesn't have or own any intellectual property unless they have gone through the process of registering a copyright or trademark or procuring a patent. However, items such as domain names, trade secrets, and the special know-how of a business constitute intellectual property which have value and for which the business and/or business owners have rights. Additionally, items such as third-party licenses (Microsoft Office, for example), IT maintenance and support contracts, and web-hosting and development contracts also constitute valuable intellectual property.   Proper consideration and handling of these items matter greatly in the sale of a business, as failure to consider or handle them properly can cause problems for the seller at the front and back end of a sale transaction.

Illustrations of unforeseen intellectual property problems in a sale transaction are set forth in the three case studies below.

Protect your Protectable Works

> **Case Study 1:** Business owner A retained an independent consultant several years ago to create a copyrightable work, but A did not register it. Thus, records were not clear from the beginning as to authorship or ownership of the copyright in the work. The work required updating over the years, which was performed on a regular basis by an employee of the business. Owner A did not secure an assignment from the independent consultant, who could not be located. As a result, neither owner A nor A's business owned the entire copyright in the updated material, and a potential buyer withdrew its offer for A's business.

There are two primary lessons to take away from Case Study 1. The first is the need for business owners to perfect their rights in copyrightable works through copyright registration. This makes a later sale of the business easier because it makes the intellectual property identifiable. If a business does not have rights to certain copyrighted material that is critical to it, the purchaser may have cause to back out of the deal or significantly reduce the purchase price to be paid for the business.

The second lesson is the need to obtain an assignment from each independent contractor at the time each is engaged that assigns to the business all work products and/or material or inventions originated as part of such independent contractor's work for the business. Again, if an independent contractor owns part of a business's intellectual property, the business owner must get permission from the independent contractor to sell such intellectual property, take a reduced purchase price, or take the chance that the purchaser will walk away.

Value Your Intellectual Property Appropriately

> **Case Study 2:** Business owner B previously registered a trademark for a product that made up approximately 60% of the gross revenues of the business purchased by purchaser P. Even though all of the assets of the business were sold to P, B retained an interest in the trademark for a period of time after the sale in order to

> secure certain obligations of P. The trademark was valued very low as part of the sale transaction, despite the fact that it covered a product that made up a majority of the business's sales revenue. When P defaulted on its post-sale obligations to B, B attempted to enforce B's rights in the trademark by taking the trademark back from P. An enforcement agent refused to transfer the trademark to B, indicating that a transfer of a nearly worthless trademark was an improper remedy to settle the parties' dispute.

In this case, by misclassifying the trademark's value during the sale process, B lessened the chances to get back a viable trademark. Correctly valuing a trademark during a sale helps a seller obtain maximum value for it but, in this case, it also would have allowed business owner B to get back the trademark after P's default. B then could have gone back into business using the trademark or sold it to another purchaser, options that were no longer available due to the misclassification.

Don't Ignore Third-Party Licenses

> **Case Study 3**: Business owner C used "Really Good Manager" software to manage inventory, accounts, payroll, etc. While 45 of the business's employees used Really Good Manager on a daily basis, C had purchased only one user license. Upon purchasing the business, P, the purchaser, found this out and (i) demanded that C pay for the 44 additional licenses or else P would sue C for breaching C's "warranties and representations" in the contract, and (ii) informed the Business Software Alliance of C's actions.

An often overlooked component of a business's intellectual property is its third-party licenses, such as licenses to use software like Microsoft Office. Sellers often fail to disclose these licenses appropriately to purchasers because they do not think they are intellectual property. In fact, they are. Moreover, many small business owners do not have enough third-party licenses to correspond to the number of employees working.

At the very least, the result is that if a purchaser discovers that the business does not have the appropriate number of licenses for its employees or contractors, it may demand an adjustment to the purchase price to offset the expense of the purchase of such third-party licenses or claim a breach of contract if the problem is discovered later. If the number of missing licenses is substantial, the adjustment required likely will be a substantial amount as well.

More troublesome, however, is the fact that the requirement to purchase licenses is policed by the Business Software Alliance. The Business Software Alliance not only can file a claim against the business for not purchasing the requisite number of third-party licenses, but also can impose punitive damages for such violations well after the violations have been mitigated. While the risk of this is relatively low if there are a small number of licenses missing, the risk becomes greater as the number of unauthorized licenses increases. The net effect to the seller is that any such damages imposed, even after closing, may fall on the seller as part of the seller's indemnification obligations to the purchaser. Disgruntled employees often are the notifiers.

Conclusion

The Case Studies above illustrate (i) the need for business owners to know and understand the intellectual property component of their businesses before putting their businesses up for sale; and (ii) that in today's world, intellectual property must be an ongoing concern of businesses, even those that are not in the business of intellectual property. Doing good intellectual property housekeeping throughout the life cycle of a business prevents problems from arising upon the sale of the business. That means a quicker, happier, and less stressful process for business owners in a sales transaction, at least with respect to intellectual property matters.

For further information regarding the issues described above, please contact Deana A. Labriola.

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