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Acquiring Intellectual Property and Other Assets Out of a Distressed Company

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Introduction

While there may be bargains when acquiring intellectual property and other assets out of a distressed company, a buyer needs to act carefully in such a purchase. The price of the asset and/or its criticality to the core business of the buyer determines how "clean" the transfer of title must be and what other due diligence is needed. Even if the cost of an asset is low, extensive due diligence may be needed if the asset will be a critical part of the buyer's business operations or products. Consider the following three examples:

(i) desks and other furniture, (ii) semiconductor fabrication equipment, and (iii) patents and other intellectual property for an electronic component that will be integrated into the buyer's primary system-on-a-chip product ("SOC"). In the case of example (i), more risk can be taken if the price is low since such assets are easily replaceable. Example (ii) likely comes at a high price and/or is important to the buyer's business operations so due diligence is very important. In example (iii), even if the cost is low, once the component is integrated into a SOC, the asset is critical to the buyer's business.

Seller's Status

The buyer should initially determine the seller's current status. The seller will be in one of five basic situations: (1) a bankruptcy under federal law, (2) an assignment for the benefit of creditors under state law ("ABC"), (3) a "workout" in which the seller is trying to settle with creditors without filing for bankruptcy or an ABC, (4) a "skeleton crew" status where only a few key employees and management continue to run the company to save remaining cash, or (5) dormant status in which the seller's status is inactive and probably uncertain.

Bankruptcy: For a buyer, the greatest certainty is purchasing an asset after bankruptcy has been filed because the bankruptcy court approves the transfer and the transfer is without any encumbrances. The most common type of bankruptcy is liquidation, a Chapter 7 filing. Prior to filing, the possibility of a seller's bankruptcy is risky to a buyer because the asset transfer could be invalidated upon the filing of the bankruptcy. The court will look at all transfers in the ninety (90) days prior to the filing to determine if assets were sold at fair market value. Too much of a bargain price may result in the court ordering that the asset be transferred back to the seller's bankrupt estate. Therefore, if a seller is on the verge of bankruptcy, the best way to buy the asset is through the bankruptcy process or an ABC.

ABC: In this type of proceeding, the distressed seller transfers its assets to a third party in trust to pay the proceeds of sale to the seller's creditors according to the priority established by law. Both the board of directors and shareholders of the seller corporation must approve the transfer. The trustee will deal with the seller's known creditors to remove encumbrances in order to make a sale possible. This approach is being used more frequently, at least in the Silicon Valley, because it can be done faster and cheaper than a bankruptcy. The ABC is immediately behind the bankruptcy in terms of the "safest" way to buy an asset. The buyer can usually obtain a limited representation from the trustee as to the status of liens on the assets being sold. The sale is likely to be "as is" with respect to the performance and other status of the assets.

Workout: In this situation, the buyer must be certain that settlements have been reached by the seller with all major creditors, secured and unsecured, particularly a creditor with a security interest in the asset to be purchased. The more creditors there are to deal with the more difficult it is to do a workout. Both the board of directors and shareholders of the seller must approve the transfer if the asset is a substantial part of the seller's business. These corporate approvals should occur if there is any possibility the asset is considered substantial.

The buyer needs to consider the "bulk sale" procedures under the Uniform Commercial Code ("UCC") when inventory is being purchased. This law has been replaced or works together with the Uniform Fraudulent Transfer Act in some states. The sale may be voided or the seller's creditors may make claims against such assets after the sale if the procedures are not followed. Exemptions include if the sale proceeds are used to satisfy a debt on such assets or the sale is an ABC. This is why it is advantageous for a seller to use an ABC or to go through bankruptcy. The bulk sale process involves notice requirements for creditors and can take several weeks to complete.

Skeleton Crew: This situation is similar to the workout situation. The seller will likely have creditors with some type of security interest or lien on most of the important assets and little or no cash. The seller will usually need board of directors, shareholder and creditor approval for the sale. A seller that is close to becoming dormant, as discussed below, may be missing some key corporate records and documentation, which leads to uncertainty. The buyer must make sure the seller has all necessary authorization to sell the assets and that it still has good title. The sale is likely to be "as is" with respect to all aspects of the asset's status. Any purported warranty will be meaningless because of the seller's economic status.

Dormant: This is the most uncertain situation. The seller's board of directors may not exist any longer and shareholders may not be available, or if available, they will not participate in the approval process. The seller has no cash. Buying assets in this situation poses the highest risk of all five basic situations. The assets should be low cost and non-critical because of the risk. Any sale will be "as is" with respect to all aspects of the asset's status. Once a company becomes dormant, it may be impossible to "find" the software, chip design or other intellectual property. Any purported warranty will be meaningless because of the seller's economic status.

Due Diligence

Several types of due diligence may be needed to assess risk: quality of title transfer, non-infringement, technical performance and employee retention/availability. Generally, it will be difficult or impossible to have any seller representations and warranties in an asset purchase agreement that meaningfully address such risks. Even if there are such representations, they may have no economic value because of the seller's distressed status. The UCC implied warranties relating to title and non-infringement will be disclaimed by the seller.

Quality of Title Transfer: Quality of title refers to transferring the basic economic interests in the asset without any encumbrances as opposed to intellectual property non-infringement. Non-infringement issues are discussed below. The U.S. has several recording systems which identify creditors, lenders, judgment holders and other lienholders in a seller's assets. The buyer needs to minimize the risk that the assets remain subject to any third-party's rights following the purchase. In some cases, an assignment may be in essence a "quit claim" in which the transfer is only as to the seller's interest, if any, in the asset.

At the state level, UCC filings cover both tangible and intangible personal property owned by a business and identify secured parties. In California, for example, security interests (called UCC-1's) are recorded in the Secretary of State's office. Tax lien and judgment lien filings also should be checked in state and county offices. The buyer needs to check all the states where the seller has either assets or performed business. These state filings are supplemented by filings in the U.S. Patent and Trademark Office and Copyright Office for trademarks, patents and copyrights, intellectual property. When critical IP assets are being purchased, these filings should also be searched since the court decisions are not totally clear on which recording system prevails.

Search services can do the state searches and are the fastest and most effective way to obtain such information. The public filings section of a Dun & Bradstreet business information report, when available, is also helpful but should be supplemented by at least a UCC-1 search.

Noninfringement: This is an evaluation of the risk of the asset infringing a third party's intellectual property. There will be no warranty of non-infringement of any type of intellectual property in a bankruptcy or ABC. Any such purported warranty will have little value because there are likely no economic means to back it up. Potential patent infringement is the most difficult to assess as it is in other situations. Possible copyright and trade secret issues should be easier to evaluate because independent development is a defense to infringement and misappropriation.

Technical Performance: Due diligence includes making sure a purchased asset works or can be made to work in a reasonable time and cost. This is a more difficult determination for technology assets such as examples (ii) and (iii). There will not likely be any warranty of performance

or, if there is, it may have little value because of the seller's distressed situation.

Employee Retention/Availability: In many cases, technical assistance, future R&D or on-going technical support will be needed to realize the value of an acquired asset. The availability of employees who have worked with the technology assets may be an important business consideration. The longer an asset remains unused the more difficult it may be to find and retain employees who understand and have worked with the asset.

Conclusion

The buyer needs to understand the importance of the asset to its future success. Due diligence will depend on the value of the asset to the buyer, rather than to the world at large. An asset with a relatively inexpensive purchase price will still require extensive diligence if it is a critical asset. Once the value is determined and diligence has been conducted, it will be up to the buyer to determine how much risk it is willing to accept.