

Intellectual Property Rights in M&A Transactions

The mergers and acquisitions market in Japan is currently experiencing more vibrancy than ever before. With this new environment, many new issues are coming to the fore, one being intellectual property considerations. Michi Yamagami and Yoshikazu Iwase discuss the issues.



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old saying that "time is money" may hold more truth than elsewhere. In seeking to get a foothold in the mobile-phone business, a new entrant would need to obtain the relevant governmental licence, a process that takes substantial amounts of time and is fraught with uncertainties. Even after the requisite licences are obtained, a new entrant would still need to spend a non-trivial amount of time to create and/or improve the value of its brand, to grow its customer base and to secure the required technologies that need to be backed by a strong IP portfolio.

In what can be considered a typical example of the use of M&A to "buy time" (although somehow unusual for Japan), Softbank, by acquiring Vodafone Japan, simultaneously obtained the telecoms licences, the customer base and an extensive IP portfolio.

Various M&A schemes

In the United States, it is not unusual to purchase a company to enhance an IP portfolio or for litigation purposes. In Japan, however, companies have only recently increased their appreciation of the importance and value of IP assets.

M&A activity aimed at acquiring IP rights (IPRs) is therefore expected to be a significant trend in Japan in the coming years. The purchase of technologies and IPRs is, for example, quite popular in the machinery, pharmaceutical and biotech industries. In the cosmetic, retail and food & beverage industries, M&A has been used to acquire brands and know-how regarding industrial secrets and recipes or distribution channels.

The following ways may be used to obtain and retain IPRs in the context of M&A activities:

- (i) specific assignment,
- (ii) licensing,
- (iii) acquisition of business, and
- (iv) acquisition of companies.

Hypothesis

Assume by way of example that an overseas pharmaceutical company with a Japanese subsidiary (the purchaser) intends to purchase another pharmaceutical company (the target), whose common shares are owned by a major shareholder in addition to minority shareholders. The target company has a licence to

The Japanese mergers and acquisitions (M&A) market is experiencing a number of changes spurred by the adoption of the new Japanese *Corporation Law*, which came into effect in May 2006. The new law, partly aimed at facilitating corporate restructuring, is expected to introduce added flexibility to company affairs, including M&A transaction procedures. There are several M&A procedures that have been revamped particularly in relation to intellectual property (IP).

The expected changes that the new *Corporation Law* will, no doubt, come at a time when Japanese companies are demonstrating a newfound dynamism in the field of M&A. Take, for example, the saga of the proposed acquisition of Hokuetsu Paper Mills, initiated by Oji Paper Co, on the premise of an offer to consolidate management of the two companies.

Another M&A area that has shown signs of newfound vigour is the use of M&A to "buy time" that would otherwise be required to participate in a particular industry or grow an already existing business.

A good example is Softbank's acquisition of Vodafone Japan, carried out in April 2006. In the telecommunications industry, the

manufacture and sell medicines, and some of the medicines it manufactures are patented, while others are licensed from overseas licensors. Furthermore, according to preliminary due diligence, the target company may have potential liability regarding defective products.

The alternative paths that the purchaser may take under Japanese *Corporation Law* are:

- (i) purchase of shares in the target company from the major shareholder and minority shareholders,
- (ii) transfer of the business,
- (iii) merger,
- (iv) corporate split, and
- (v) share-for-share exchange.

Choosing a route requires legal analysis and also analyses from the tax and accounting perspectives.

Major points to be considered for each alternative from a legal perspective are the transfer of the rights and obligations (such as (x) contract and (y) contingent liability); and the necessary legal procedures.

Note that the transferability of the regulatory licence is subject to relevant regulations. The purchaser should research such regulations to evaluate the transferability of the business licence. The discussion below is limited to *Corporation Law*.

(i) Purchase of shares

The purchaser would buy shares of the target company under agreement with the major and minority shareholders. This is the simplest alternative in that there is no change in the target company's rights and/or obligations. As such, the regulatory licence would generally continue to be effective, as would be the pharmaceutical licence, and the contract would remain effective unless it contained change-of-control provisions. The purchaser would risk the contingent liability of the target company to the extent of its investment in it (limited liability).

As for the procedures of the share purchase itself, board approval may be required for each party depending on the size of the parties and the total value of the shares to be transferred or acquired. In addition, if the target company's articles of incorporation contain share-transfer restrictions, the share transfer may need to be approved.

(ii) Business transfer

The purchaser would purchase all, or a substantial part of, the target company's business. Since the purchaser can select and specify

the rights and obligations to be acquired in the business-transfer agreement, the risk of assuming contingent liabilities from the target company can be avoided. However, in order to transfer the agreements (for example, the licence agreement in this hypothesis), consent will be required from the counterparties of the respective agreements.

Provided that transfer of the licences is made regarding patent, utility model or design rights, transfer of the relevant business would be valid without the patent-holder's consent. In addition, typically the regulatory licence will not be transferred as a result of the business transfer under relevant regulations (as is the case with the pharmaceutical licence) and, unless it already has such licence, the purchaser would be required to obtain it.

As for legal procedures, the target company shall obtain approval of the business transfer by a two-thirds majority of the total number of votes held by the shareholders present at the shareholders' meeting (special shareholders' approval). The target company will be required to provide dissenting minority shareholders with an opportunity to exercise appraisal rights (ie: minority shareholders' protection procedures). If the purchaser were only to acquire a substantial part of the target company's business, board approval would be sufficient. On the other hand, if the purchaser acquired all of the target company's business, shareholders' approval would be required and procedures would need to be taken to protect minority shareholders.

(iii) Merger

In this case, the target company would merge into the purchaser, or the other way round. Assuming the purchaser is the surviving company, all rights and obligations, including contingent liabilities, of the target company will be transferred to the purchaser by operation of law.

In exchange for the transfer of these rights and obligations, the purchaser typically issues its shares to shareholders of the target company.

Note that where certain agreements of the target company contain negative covenants regarding a merger, they may be terminated due to a breach of the agreement following the merger, even though such an agreement would be transferred to the purchaser as a result of the merger.

As such, the target company should obtain the other party's consent to the agreement. Also, generally speaking, the regulatory licence would not be transferred to the purchaser as is the case with the pharmaceutical licence. Although the title transfer will occur as

a result of the merger, the perfection procedures for such a transfer (if any) should be performed separately in order to claim such title transfer against third parties.

As for IPRs, however, registration is not required for their valid transfer, while the law requires that the Japan Patent Office (JPO) be notified without delay of the transfer of IPRs as a part of merger or other general transfer.

As for legal procedures, special shareholders' approval and the minority shareholders' protection procedures are required for the purchaser and the target company. Both parties are required to undertake creditor-protection procedures (namely, repayment of obligations to dissenting creditors).

(iv) Corporate split

The target company and the purchaser will enter into a corporate split agreement. Thereafter the rights and obligations, as specified in the agreement, will be transferred from the target company to the purchaser and, in consideration therefore, the purchaser will typically issue new shares to the target company.

The purchaser will not inherit any contingent liability owed by the target company so long as such liability is not specified in the corporate-split agreement as being transferred to the purchaser.

The contracts specified in the corporate-split agreement will be transferred from the target company to the purchaser by operation of law and consent from the other contracting party will not be required.

Note that similar to a merger, to avoid the subsequent termination of the agreement, consent must be obtained from the other party in agreements containing negative covenants regarding a corporate split.

The regulatory licence would not usually be transferred as a result of a corporate split, as is the case with the pharmaceutical licence. As for transfer of IPs upon corporate split, the rules equivalent to a merger will apply.

As for legal procedures, special shareholders' approval and the minority shareholders' protection procedures are required for the purchaser and the target company. Both parties are required to undertake creditor-protection procedures. In addition, the target company must follow the required procedure in order to transfer the relevant employment relationships from itself to the purchaser.

(v) Share-for-share exchange

In a share-for-share exchange, all shares will be transferred to the purchaser by operation of law and the purchaser will typically issue new shares to the target company's shareholders in exchange. Since the target company's rights and obligations would not be affected as a result of the share exchange, share-purchase analysis will apply. As for legal procedures, special shareholders' approval and the minority shareholders' protection procedure will be required by the purchaser and the target company.

Impact of the new Corporation Law

Some M&A procedures have become more flexible as a result of the newly implemented *Corporation Law*.

(i) Flexibility of the merger consideration

The consideration given in case of a merger, corporate split or share-for-share exchange used to be limited to shares of the acquiring company or such shares together with cash. Merger considerations will become more flexible from May 2007 when, under the new *Corporation Law*, the exclusive use of cash, the use of shares of the parent company or of other assets may be used as consideration.

As a result, squeeze-out/cash-out transactions and triangular mergers that do not affect the capital structure of the purchaser may occur. There are also discussions regarding whether a cash-out merger may be invalidated in case of abuse of the right to implement the merger by the controlling shareholders. At this point, there is no precedent and the discussion has not yet been settled.

(ii) Short-form mergers and minor merger

As stated, various M&A transactions generally require shareholders' approval. The *Corporation Law* provides certain exceptions to this rule, one of which is an M&A transaction between controlled and controlling corporations (short-form mergers).

In the event that the controlling corporation holds 90% of the voting shares in the controlled corporation, no shareholders' approval is required for the controlled corporation.

Another exception concerns minor mergers. Under the *Corporation Law*, if the merger consideration is 20% or less of the net assets of the surviving company, shareholders' approval of the surviving company can be dispensed with. There are equivalent exceptions regarding corporate split and share-for-share exchange as well.

Intellectual property considerations in M&A

In M&A transactions, IPRs are one of the most important items to be checked during the due diligence process. The IPR transfer process and the transfer of the obligations accompanying IPRs should be a

major consideration in M&A transactions.

Among other issues, confirmation of ownership is key. Registration of patent, utility model, design and trademark rights is handled by the JPO and the ownership of such rights can be verified with JPO records. Registration of copyrights is handled by the Agency for Cultural Affairs, while software copyrights are handled by the Software Information Center. The copyright registration systems are not frequently used, thus copyright ownership should be checked based on materials reflecting copyrighted works and employee interviews.

Procedures for the transfer

Patent rights

A patent right is granted upon registration, after examination by the JPO. In order for the transfer of a patent right to be valid, the transfer must be registered. A licensee needs to register the transfer to successfully claim the grant of the licence against third parties.

This is provided, however, that the registration is not required for the acquisition of IPRs to be valid in case of a merger or another general transfer where the law provides that it shall notify the JPO without delay.

Registration is required for the grant of a statutory exclusive (*senyo-jisshiken*) licence to be valid. On the other hand, no registration is required for the grant of a non-exclusive (*tsujo-jissiken*) licence (including contractually exclusive licence) to be valid.

In both cases, registration is required to claim a licence against a third party. Where a licensor assigns a patent right to a third party, registration of the licence is required to claim a licence against the new patentee. A typical practice designed to prevent the unexpected assignment that may lead to the licence becoming extinct is the inclusion of a contractual prohibition of assignment of the patent rights, without the consent of the licensee.

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Copyrights

A copyright arises, with no need for registration, at the time of completion of creation of the copyrightable item. A copyright holder can sue an alleged infringer without registration. Unlike patent rights, a copyright can be transferred without registration. However, registration is required for a transferee to claim the transferred copyright against a third party. Where concurrent multiple assignments are made, the assignee who obtains registration of the assignment first is entitled to claim its right against other alleged assignee(s). Yet, the significance of a copyright registration is limited, and generally speaking, the copyright registration system is not commonly used.

A copyright is a bundle of various rights, which can be collectively transferred. Article 61-2, purporting to protect assignors of copyrights from assigning their rights under unreasonable terms, provides that the right to adaptation under article 27 and right to use of derivative works of the owner of the right to the original work under article 28 is presumed to remain, unless the transfer of each right is specifically set out in a contract. Commentators believe that "all the copyright" or "any and all rights" are not specific enough to satisfy this requirement. Therefore, this should be noted in drafting an agreement from the assignee side.

Obligations regarding IP

While IPRs are an asset, obligations occur when they are obtained. Notable, among others, are the obligations regarding corporate employees' inventions or works, since this may give rise to contingent liability on the purchaser of a business or company as regards:

- (i) ownership (ie: whether a company can obtain its employees' inventions and works); and
- (ii) even if the company obtains them, whether and how much it will have to compensate its employees.

Regarding issue (i), the systems are totally different between patent rights and copyrights. The patent right, or the right to obtain a patent right, is always vested in an employee first. Such a right belongs to the employee unless there is an assignment contract between the company and the employee. On the other hand, the copyright of a work made by an employee in the course of his/her

duties with his/her company belongs to the company.

Regarding issue (ii), there is a major difference between patent rights and copyrights. The *Patent Law* provides that a company shall pay reasonable compensation to its employee where it assigns an invention made by the employee. There have been many recent court cases involving large amounts of compensation in this regard, with a district court awarding an inventor the unprecedented sum of ¥40 billion (US\$342 million). Where a company purchases stocks and obtains patent rights as part of a general transfer, the purchaser company will be liable to pay "reasonable compensation" should the inventor not have been fully paid.

The issue is controversial as to whether a company that purchases businesses of another company, including patent rights, incurs liability to compensate an inventor. In either case, the purchaser company may be liable to pay reasonable compensation to the employee of the target company. Therefore, the purchaser company should check whether "reasonable" compensation has been paid to inventors when conducting its due diligence before buying the company or business.

About the authors

Michi Yamagami is a senior associate with Anderson Mori & Tomotsune. His main areas of practice are M&A, corporation law and securities law. He is admitted to practice in Japan and New York. Yamagami earned a Bachelor of Laws degree from the University of Tokyo, Faculty of Law, and a Master of Laws degree from University of Southern California Law School. He has trained with the Los Angeles office of Paul, Hastings, Janofsky and Walker. He speaks Japanese and English.

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Suggestions? Comments? Questions?

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