



**INTELLECTUAL
PROPERTY
AUDIT &
DUE DILIGENCE**

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INTELLECTUAL PROPERTY AUDIT & DUE DILIGENCE

Intellectual Property (IP) assets are important to businesses of all sizes which strive to maintain a competitive edge. A thorough understanding of your IP assets - their creation, application, efficiency, uniqueness, exclusivity, enforcement and valuation is essential to properly utilize these assets to maintain market dominance, sustainability and continuing profitability.

For a basic understanding of IP assets, please refer to Hong Kong – The IP Trading Hub (www.ip.gov.hk).

WHAT IS IP AUDIT?

It is a systematic, comprehensive and periodic review of your IP assets against ever-changing customer expectations and market conditions to ensure that:

- 1) Important IP assets are identified and properly managed
- 2) IP-based collateralized financing terms are complied with
- 3) Idle IP assets may be better commercialized or disposed of
- 4) Opportunities for IP collaboration are timely identified and explored
- 5) Infringement threats and risks are identified and resolved at the earliest opportunity
- 6) Resources are timely allocated and adapted to changing needs and new or better opportunities

HOW TO CONDUCT AN IP AUDIT?

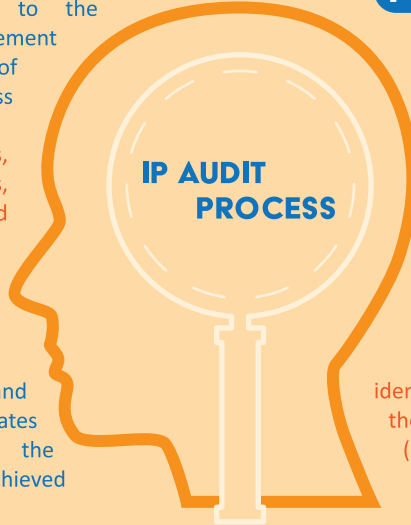


The frequency, process, system, perspective or vision needed to conduct this effectively is not set in stone. No one size fits all. Every method or model should be adjusted considering the nature, type and size of your business, the IP assets involved and the market condition. Besides your IP assets, an understanding of your business culture and strategy, interaction with employees and third party contractors, market position against the market environment and the relevant IP laws will help to define an audit that is comprehensive, focused and cost-efficient.

The process will involve a careful review of:



- 1** Documents such as assignments, licences, employment contracts, independent contractor agreements, confidentiality agreements, joint venture agreements, collaboration agreements, grants conditions, financing agreements, distributorship agreements, consultancy agreements, research contracts, outsourcing agreements etc. together with professional opinions which relate to the ownership, validity, infringement risk, use and enforcement of the IP assets of the business
- 2** Copyright works, designs, trade mark materials, confidential documents and their modifications to ensure safe keeping of original works and proper records of use
- 3** Updates on research and work-in-progress and updates on the timeline when the expected results may be achieved
- 4** Updates on IP applications and contemplated conflicts and the commercial justification to continue
- 5** The terms and conditions, and company policy regarding the provision or use of computer software, particularly generative artificial intelligence tools, to create IP and how that may impact upon the subsistence and ownership of the IP rights
- 6** The latest tax deductions, concessions and other incentives which may be available for IP creation, acquisition or exploitation and if the requirements are met
- 7** Documents which contain any no-challenge or non-compete obligations to assess the impact of the restrictions or limitations and their reasonableness or if these restrictions are imposed on the other side, to review their enforceability
- 8** The efficiency of the operation, the processes and persons involved to identify the creation of IP assets, their reporting and maintenance (especially confidentiality) and to alert and report on risks and potential problems
- 9** Information, disputes, actions and proceedings which threaten or challenge the validity of the IP rights to assess the level of risks involved and to formulate a solution or to evaluate the efficacy of any enforcement action



Instead of being reactive to a situation, an audit can provide proactive insights to prevent future problems. The process may also involve educating staff about IP awareness (see IP Manager Training Programme - <https://www.ip.gov.hk/en/key-programmes/index.html>), interviewing staff, inspecting workspace, updating policies, security systems and data searches.

Many of the issues are largely the same as those in an IP due diligence exercise, which is a form of IP audit for a specific financial, commercial or legal purpose often linked to the buying, selling or financing of the valuable IP assets of a business. As the issues will be better demonstrated in the IP due diligence section later, here are just a few fundamental points to give you an idea of the steps in conducting an IP audit:

1 Identifying and recording your IP assets

This is a basic stock-taking exercise to create or update your IP portfolio. During such exercise, you should identify and pay particular attention to your core IPs (business drivers):-

Ownership / Right to use - Are they self-owned, if not, what are the limitations of the rights to use and how can the situation be improved? What is your proof of ownership or right to use? These questions require a review of your employment and independent contractor agreements, IP assignments and licences, collaboration and joint venture agreements, financing agreements (especially IP-based collateralization) and terms of government, university or third party IP grants, subsidies or loans.

Computer-generated works - What needs to be fulfilled to ensure subsistence and ownership of IP?

Application and Registration - If your IP assets are capable of being registered, are they timely applied for, adequately registered and properly maintained? Are the key dates properly identified and marked in the diary? Is the scope of application, registration and countries applied for or registered adequate? Are amendments required and how these may be made? If not capable of registration, how are the IP rights protected and is such protection effective?



2 Core and idle assets

Are your core IPs used effectively and fully exploited? Can these be improved and how can such improvements be protected?

Are idle IPs still useful for you to maintain a competitive edge? If not, can they be licensed or disposed of? Meanwhile, should registrations be maintained or be allowed to lapse?

3 *Identifying and evaluating weaknesses*



Does any ownership problem exist and how can this be resolved?

How dependent is your IP on third party IPs to function effectively? Can this be improved? Is it possible for your IP to be independent and self-sufficient?

Are there any time, territorial or market sector restrictions or limitations on your right to use the relevant IPs? Can the restrictions be relaxed or overcome, how and when?

How much of a competitive edge do you really enjoy? Is it easy to get around your IP exclusivity? How much longer can you enjoy such exclusivity and what would happen next?

Are there potential threats or risks of infringement and is a proper reporting protocol in place to alert and handle the same? What enforcement or defence strategies should be adopted and what are the financial implications? Are the risks manageable?

Are quick market changes contemplated and if so, are your IP assets adaptive enough?

In respect of those IP rights registered without substantive examination, how strong are they and how do you prove their validity?



4 *Opportunities for collaboration*

Is the nature of your product or the technology involved suitable for collaboration?

Does the lifecycle of your product or technology demand fast innovation?

Who are the potential collaborative partners?

What are the goals to be achieved and can these be achieved through your own resources such as budget, expertise, IP capability and are these goals sustainable?

Is your corporate culture ready to adopt a non-adversarial mind-set and be willing to share and collaborate?

What may be the duration for collaboration?

What will be the exit strategy and consequences?



5 Notable transactions

Licensing of IP assets should be reviewed to ensure licensees comply with conditions of use.

Security interests, priorities (options, first rights etc.) and encumbrances created should be duly recorded and associated restrictions noted and adhered to.

6 Recommendations

The audit report should conclude with:-

- a) an analysis and forecast of the market trend for your products/ services
- b) an identification of any collaborative, new or expanded market opportunities for your IPs
- c) an evaluation whether your IP assets can continue to serve the business and strategic objectives of your operation and are adaptive to changes and foreseeable challenges
- d) whether resources should be allocated to develop new IP rights alone or in collaboration with others
- e) whether your template contracts may have to be revised to enhance your IP rights
- f) confirmation of compliance of restrictive terms in material contracts
- g) recommendations for any change of your business model and IP management policies
- h) recommendations whether non-core or idle IPs be revived, monetized or left to expire
- i) recommendations to resolve any threats or risks of infringement; and
- j) recommendations for an enforcement strategy.



WHAT IS IP DUE DILIGENCE?

It is a special purpose IP audit where an IP portfolio is defined, examined and analyzed on its strength, scope and enforceability to evaluate the value for a transaction. It is often conducted for mergers and acquisitions, joint ventures, licensing, assignments, venture capital financing and securitization of IP assets.

Just as business transactions vary, the nature and scope of IP due diligence in each deal will have its own characteristics and requirements affected by a number of factors such as the industry practice, the sophistication and expectations of the parties, the completeness and reliability of records, the volume of documentation, the locations of the IP assets and the applicable laws, the need for overseas counsel input and translations, the history of business, time and cost constraints.

HOW TO CONDUCT AN IP DUE DILIGENCE?

The extent of IP Due Diligence is often determined by the value of the deal, the importance, nature and location of the IP assets and the parties' familiarity with each other and their risk tolerance levels. The exercise often starts with verifying the accuracy and completeness of a list of the IP assets provided by the other party.

The process is dynamic and new tasks, areas for investigation and challenges may arise when new facts are uncovered as the exercise progresses. It is both important and useful to identify the ultimate objective of the exercise to set its priorities and define its scope and timeline.

Here are some common steps and questions to be asked in conducting an IP Due Diligence:-

Define and Prioritise

The first and foremost question is - why is the transaction structured the way it is and what do you expect to benefit from it? In this context, what IP assets will be assigned/ transferred/ used and what is their significance to the transaction and to your future business?

1

Verify Records

You need to check whether there are independent sources available to verify the information you have been provided. If yes, are those sources up-to-date and reliable and what will be the coverage, cost and time involved?

3

When records are produced, are they complete particularly in respect of ownership and right to use? Where registrations are involved, were they granted without substantive examination? Are there any encumbrances (such as security interests, licences) or priority rights and are they registrable with any official registry under the relevant jurisdiction for searching and what are the consequences of non-registration?

With respect to unregistered rights or rights pending registration, you may have to find out if prior art, clearance, or infringement studies have been conducted and review the advices given.

Identify the IP Assets

Are the IP assets in issue adequate for the objectives? If not, what else may be needed and do they have to be procured from another source? Are there overseas rights and are they consistent in different territories? Is ownership, validity and freedom to use the IP assets clear? Is there any reservation of rights and will this affect future rights and activities? How long are the IP assets still valid for and is it long enough for the purposes of the transaction?

2

4

Check for Validity and Enforceability Concerns

You should find out the history of infringement claims, enforcement (mediation, arbitration and litigation) and outcome, particularly whether there has been any dispute, challenge or impact upon the validity and ownership of the rights. This is particularly important where the IP right granted was without substantive examination. If such examination may be requested under the applicable law, whether it should be carried out.



Investigate and Check for Third Party Rights

5

Third party rights may exist under various circumstances. For example, an employee whose works are used outside the original reasonable contemplation of his employment and an employee whose invention is of outstanding benefit to his employer may be entitled to an award. In case of commissioned works, has the copyright passed to the commissioning party? In research and development, grants and subsidies agreements and consultancy contracts, do the terms clearly identify ownership as the parties intended and do they cover IP rights created from customization, modifications and improvements?

Where there is co-ownership of rights, this can mean different rights in different jurisdictions. In some jurisdictions, a co-owner can himself exploit the IP without the intervention and consent of the other co-owners where in other jurisdictions he can't. Likewise, in some countries, a co-owner may grant licence but in others, all co-owners must agree before a licence can be granted. It is hence important to make sure that the rights of the respective co-owners are clear.

6

Review the Law

Any threatened and actual mediation, arbitral or court proceedings (past and present) involving the IP assets should be carefully reviewed to determine their possible impact. In particular, mediation and arbitration are private and confidential in nature and the outcome is often known only between the parties. You should also be vigilant whether any recent or prospective change in the law may impact upon the IP rights.



Analyze the Outcome

By the time of the analysis, your legal advisor should be able to provide not only an up-to-date status of the IP portfolio but also an identification of its strengths and weaknesses.

7



8

Risk Assessment and Solutions

Where there are doubts or defects in the IP assets, you should consult with your legal advisor how these may be resolved and the extent of warranties and indemnities you should seek from the vendor, and whether there are solutions or methods as to how the risks may be managed or minimised. In the absence of a satisfactory resolution, perhaps the acquisition price needs to be renegotiated? Do you need any conditions precedent or subsequent? And if the defect is fundamental and cannot be satisfactorily remedied or if the risk too high, should this be a deal-breaker?

DIFFERENT IP ISSUES

Different IP rights have their own characteristics and give rise to different issues. The discussions below are intended to be illustrative to trigger off investigations and are not meant to be exhaustive.



COPYRIGHT

As there is no copyright registration in Hong Kong, you need good evidence (preferably documentary evidence) to substantiate the subsistence, ownership and scope of copyright protection. Such evidence includes the name of the owner, the mode of acquisition of ownership, the full name of the author (his place of domicile, residence or right of abode for an individual author and its place of incorporation or principal place of business for a corporate author), the date and place where the copyright work was made or first published together with the originals or true copies of the copyright works. You need also to check whether the original authors have asserted any moral rights which shall be respected.

Our copyright law provides that in the case of literary, dramatic, musical or artistic work which is computer-generated, the author is taken to be the person by whom the arrangements necessary for the creation of the work are undertaken. This should apply to works created from use of generative artificial intelligence. On the other hand, the US Copyright Office has repeatedly denied copyright protection for art created using AI. The US courts have also decided that a valid copyright requires human, not machine, authorship. As this area of the law is evolving and jurisdictional copyright law in this respect may differ, besides the usual information in the first paragraph above, it is strongly advisable to keep full record and information about the computer arrangements, the software used, the instructions given and the person(s) who gave and input the instructions.



REGISTERED DESIGNS

In Hong Kong, a registered design can be applied for the shape, configuration, pattern or ornament applied to any article by any industrial process, which is new and appeals to the eye. As the Hong Kong design registration system does not require substantive examination, registration alone is not a complete assurance of valid rights. Likewise, you need evidence similar to those for proving copyright subsistence and ownership. You also need to check that the registration has not been invalidated by prior disclosure and is properly maintained, the remaining period of protection and whether there are corresponding overseas registrations.



PATENTS

In Hong Kong, patent protection is only granted for inventions. A standard patent can be protected for a maximum of 20 years from the deemed date of filing of the application and a short-term patent 8 years. A short-term patent does not require substantive examination. A proprietor of a short-term patent and, in certain circumstances, a third party can request the Registrar to conduct a post-grant substantive examination. The result of this procedure will be the issuance of a “certificate of substantive examination” confirming the validity of the patent (including any requested amendments) or, in the event the patent is ultimately found invalid, its revocation. It is now a requirement for commencing enforcement proceedings in respect of a short-term patent before the court that a request for substantive examination be made or a certificate of substantive examination adduced.

You need to check that the inventors have properly assigned their rights (including relevant but unfiled inventions) and the chain of title is complete. Besides Hong Kong, are overseas registrations important and has the patent been properly registered in all other relevant jurisdictions?

In addition to checking the usual registration particulars, for core patents, you should check whether there was any prior disclosure which may impact upon validity, the prosecution history, the citations overcome, the scope of the specifications, the freedom-to-operate or clearance opinions received and infringement assessments (if any). You also have to assess the ease to get around the patent, the state-of-the-art and the reliance on third party rights to properly assess the value of the patent. If there are improvements, are they included and patented? Has there been any enforcement and the validity of the patent challenged and confirmed in court? What was the outcome of any infringement dispute?



TRADE MARKS

These in Hong Kong can be protected under the Trade Marks Ordinance and the common law of passing off and can include distinctive trade dress and slogans as well. Virtual goods can be registered in Class 9 (which includes mainly apparatus and instruments for scientific or research purposes, audiovisual and information technology equipment, as well as safety and life-saving equipment) and services provided in online and/or virtual environments are classified according to the established principles of classification, having regard to their underlying nature, and their purposes in the physical world. Besides, trade mark protection is expanded to cover domain name registrations, social media accounts, adwords, and tag lines as well.

You need to check whether the key marks are registered in the appropriate classes in Hong Kong and overseas (at least the place of manufacture and major markets) and whether the mark may enjoy enhanced protection as a well-known mark. Where appropriate, have foreign language versions been registered? Are there any identical or similar marks in the



TRADE MARKS

market and whether such co-existence is or must be tolerated? If not, can actions be taken or is it too late? Is there evidence and proper record of the creation, first use and history of use of the mark in case its validity or distinctiveness is challenged? Are there any potential opposition, cancellation or revocation challenges?

Have the key domains been registered and who is responsible for maintaining them?

If the mark is unregistered or unregistrable, can it be protected at all and if so, through what means?

For well-known marks, are the factors for determination in Schedule 2 of the Trade Marks Ordinance met?

To prove passing off, the first prerequisite is to prove goodwill and this is typically by reference to (impressive) sales and advertising figures for a period of time.



CONFIDENTIAL INFORMATION

Business information is only confidential if it has the necessary quality of confidence about it and proper steps have been taken to preserve its confidentiality. You need to check that such information is properly identified, recorded and protected, that such information is complete, reliable and accurate, and that all persons who had access are identified and are subject to a duty (preferably contractual or fiduciary) of confidentiality.



KEY EMPLOYEES

Especially in the context of M&A, it is important that key employees remain given their status, know-how or networks. If there is no confirmed commitment that they may stay, you need to ascertain if there are any non-compete restrictive covenants against them and if those are enforceable.



DISPUTE

Is it actual, pending or threatened? Will you be on the offensive or the defensive? What are the IP rights involved and at the core of the dispute? Will it be resolved by mediation, arbitration or litigation and will there be administrative or criminal sanctions? What is a fair assessment of the impact of such dispute and the probable outcome on the business? What is the fall-back or future plan?

Important Reminder

These days, many IP assets involve transnational elements. Despite international conventions and treaties, IP rights may still be treated differently in different countries. Hence, you must not make assumptions about foreign IP assets based upon an understanding of Hong Kong laws. It is prudent to instruct overseas advisors to assist.

Disclaimer

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