INTERNATIONAL MERGERS & ACQUISITIONS: THE CANADIAN PERSPECTIVE

Francois Painchaud, Louis-Pierre Gravelle,
Panagiota Koutsogiannis, Christian Danis and Marie-Ève Côté*
LEGER ROBIC RICHARD, Lawyers,
ROBIC, Patent & Trademark Agents
Centre CDP Capital
1001 Square-Victoria - Bloc E – 8th Floor
Montreal, Quebec, Canada H2Z 2B7
Tel.: (514) 987 6242 - Fax: (514) 845 7874
info@robic.com – www.robic.ca

---

* Lawyers with the law firm LEGER ROBIC RICHARD, g.p. and with the patent and trademark agency firm ROBIC, g.p.

1. Introduction: Nature of the Business and Value of the Intellectual Property

Economic prosperity in Canada, just as in other industrialized nations, has come to rely more and more on non-traditional manufacturing sectors based primarily on information and bio-technology. In this environment, intellectual property continues to take on an ever-increasing role in the valuation of a corporate enterprise.

In Canada, the existence of a right in intellectual property is generally a creature of statute. Such statutes include the *Patent Act*[1], the *Copyright Act*[2], the *Trade-marks Act*[3] and the *Industrial Design Act*[4] and also more esoteric

[1] *Patent Act*, R.S. 1985, c. P-4 , http://laws.justice.gc.ca/en/P-4/index.html
[2] *Copyright Act*, R.S.C. 1985, c. c-42, http://laws.justice.gc.ca/en/C-42/index.html
[3] *Trade-marks Act*, R.S.C. 1985, c. T-13. http://laws.justice.gc.ca/en/T-13/index.html
[4] *Industrial Design Act*, R.S., 1985, c. I-9. http://laws.justice.gc.ca/en/I-9/index.html

forms such as the *Integrated Circuit Topography Act*[5] and the *Plant Breeders' Rights Act*[6].

There are also a number of non-statutory intellectual property rights, including rights with respect to trade secrets, know-how and confidential information. These are subject to provincial laws, which vary from one province to the other, and this may have an impact on the manner in which the intellectual property in question may be dealt with.

As many high-tech start-up companies consist of virtually no fixed assets, but primarily of a small number of technological assets and a handful of key people[7], a diligent and accurate evaluation of an enterprise's intellectual property is an invaluable tool when seeking to reduce risk in the course of a corporate merger or acquisition. Furthermore, when the real worth of a company is thought to reside in an important intellectual property asset, the prospective investor may often be so overwhelmed by this asset and its potential market that general business caution is suppressed.[8]

Duality of the Canadian Legal Regime

Within the private law sphere, Canada has inherited from two distinct legal systems: the English Common Law from the United Kingdom and the French Civil Law from France. The Civil Law is governing private relations in Quebec and the Common Law applies for the same to the other nine provinces. Those two systems have been firmly entrenched in the provinces they respectively cover and they have managed to coexist while evolving in parallel one to another. As a result, there are some variations between the two systems, notably in the classification and treatment of property rights, that may have an impact in the course of transactions involving intellectual property. Fortunately, since Canada is a confederation, most of the statutes related to intellectual property are to be found at the federal level, which applies to all provinces, irrespective of their legal system. Throughout this chapter, where relevant, a distinction will be made between the common law and civil law approach for a given situation, in order to take into account this duality of the Canadian legal regime.

---

[5] *Integrated Circuit Topography Act*, 1990, c. 37. http://laws.justice.gc.ca//en/I-14.6/index.html

[6] *Plant Breeders' Rights Act*, 1990, c. 20. http://laws.justice.gc.ca/en/P-14.6/index.html

[7] George S. Takach, *High Tech M&A: The Preparation Stage*, Lexpert, April 2000 at p.109.

[8] Daniel Bereskin, *Due Diligence: Getting the Facts and Defining the Issues*.

2 Overview of the Transaction: Objective, Scope and Costs

The potential parties to a merger or an acquisition are interested in ensuring themselves of some very basic facts:

1. defining the relationship between the target company and the subject technology, to make sure that it is the sole owner or licensee of such technology;
2. protection has been properly secured;
3. all of the delays inherent in the various national and regional juridictions have been respected;
4. inventions have not been disclosed publicly to the extent that patent protection is lost;
5. the extent to which other parties may already have had access to the target's technology;
6. the extent to which secrecy has been maintained on non-patentable or non-patented technology and the potential risks of maintaining the secrecy of such information;
7. the possibility that future use of the technology of the target company may violate the prior existing rights of third parties.

One of the goals of a due diligence investigation is to ensure that a business has been managed in an orderly fashion. There are three issues at the center of any due diligence concerning intellectual property:[9]

1. Establishing a chain of title or rights with regard to the property;
2. Identifying any potential infringement; and
3. Ensuring that there are no outstanding claims against the intellectual property, including demands, judgements, security interests, contractual restrictions or current or pending litigation.

When intellectual property is not the main asset but only one type of asset among others in a transaction, there is a risk of underestimating both its value and consequently the time and money that should be devoted to proper due diligence in that area. Since the legal fees are often dependent on the value of the transaction, there is no practical mean to estimate how many resources should be allocated to the intellectual property part of the due diligence. In many cases, if 10% of the legal fees are devoted to it, it would be considered appropriate, but this greatly depends on the particular circumstances of the transaction. Obviously, disbursements related to searches at the national and international levels may represent a relatively

---

[9] Robert Michelin, *Establishing ownership in intellectual property: Due Diligence Requirements*, Journal du Barreau, October 1st 1997 at p.21.

large portion of those costs, since intellectual property rights often rely heavily on registration.

It is important to remember that ownership of the technology is one of the most important issues in a due diligence audit concerning intellectual property.[10] When there is only one owner of a patent for example we can more easily determine the rights of such owner and trace the rights granted by such owner to third parties. However, when intellectual properties are jointly held by several persons, these issues become more difficult.

Mergers, Competition Law and Intellectual Property

IP and competition laws complement each other in promoting an efficient economy. IP laws provide incentives for innovation and technological diffusion by establishing enforceable property rights while competition laws may be invoked when these rights are used in anti-competitive practices that create, enhance or maintain market power or otherwise harm competition.

In Canada, the competition aspects of any merger are governed by the *Competition Act*[11], which is administered by the Competition Bureau of Canada[12] (hereinafter: the "Bureau"). Private cases are limited to section 36 of the *Competition Act*, which provides for civil damages if a person suffered damages as a result of a breach of Part VI (offences in relation to competition) or for violation of an order of the Competition Tribunal. This provision has however rarely been used up to now.

Remedies or injunctive relief may be ordered by the Competition Tribunal for breaches of the *Competition Act's Part VIII* reviewable practices provisions, but no civil action may be based on a breach of those provisions. Parts VIII and IX of the *Competition Act* and associated regulations govern the competitive effects of a merger. A merger is defined at section 91 as:

> "*the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person.*"

---

[10] Cynthia Ledgley, *Examining Pros and Cons of Intellectual Property Audits* at p.103

[11] Competition Act (R.S. 1985, c. C-34), http://laws.justice.gc.ca/en/C-34/index.html

[12] http://strategis.ic.gc.ca/ssg/ct01250e.html

According to the Merger Enforcement Guidelines[13] the principal issue to be considered in a merger proposal is the interpretation of the words "significant interest". The Merger Guidelines state that the acquisition or establishment of a significant interest in the whole or a part of a business of another person is considered to occur when a person acquires or establishes the ability to materially influence the economic behavior of the business of a second person.

Pursuant to subsection 92(1) of the *Competition Act*, if it is found that a merger prevents or lessens, or is likely to prevent or lessen, competition substantially in a trade, industry or profession or among the sources from which a trade, industry or profession obtains a product, amongst others, the Competition Tribunal may order the merger not to proceed or to be dissolved, order assets disposed of as it directs, prohibit the doing of any act or thing the prohibition of which the competition Tribunal determines to be necessary to ensure that the merger does not prevent or lessen competition substantially, or take any other action.

Section 93 of the *Competition Act* goes on to provide a number of factors which may be used in determining whether or not a merger prevents or lessens competition substantially. For example, the Tribunal may have regard to, amongst others, the extent to which acceptable substitutes for products supplied by the parties to the merger or proposed merger are or are likely to be available, the extent to which effective competition would remain in a market that is affected by the merger, or the nature and extent of change and innovation in a relevant market.

In this regard the Merger Guidelines hold that mergers generally will not be challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merged entity would be less than 35 percent. The Merger Guidelines further states that in a similar fashion, mergers generally will not be challenged on the basis of concerns relating to the interdependent exercise of market power, where the share of the market accounted for by the largest four firms in the market post-merger would be less than 65 percent.

In some cases, pre-notification of a merger to the Director of the Bureau is required. Whether or not the pre-notification is necessary is a function of the aggregate size of the merging companies' assets or annual gross revenues, including affiliates (section 109 of the *Competition Act*, $400,000,000 in Canadian funds) <u>and,</u> in general terms, the size of the proposed transaction

---

[13] Competition Bureau, *Merger Enforcement Guidelines*, January 24th, 1997 (hereinafter the "Merger Guidelines").

(section 110 of the *Competition Act*, $35,000,000 in Canadian funds, or $70,000,000 in the case of an amalgamation *per se*), unless exempted[14]. In such cases there is a mandatory waiting period within which the Director has the opportunity to challenge the merger after the required information has been received by the Director[15]. However, even if pre-notification is not required, a merger may still be challenged on the basis of section 92 of the *Competition Act*. Section 102 of the *Competition Act* also provides for the possibility of binding advance ruling certificates upon application.

2.3 The Competition Bureau and the Intellectual Property Enforcement Guidelines

Traditionally, the Bureau was not very severe in reviewing IP transactions unless they fell into the merger category. The Competition Tribunal may apply the general provisions of the *Competition Act* to anti-competitive practices incidentally involving IP such as conspiracy, bid-rigging, market allocation or mergers. However the mere exercise of an IP right will not give rise to an anti-competitive practice captured by the general anti-competitive provisions. To counter any abuse that may arise given the statutory grant of exclusion for a large portion of IP, subsection 32(1) was enacted, which reads as follows:

> *"32. (1) In any case where use has been made of the exclusive rights and privileges conferred by one or more patents for invention, by one or more trade-marks, by a copyright or by a registered integrated circuit topography, so as to*
>
> *(a) limit unduly the facilities for transporting, producing, manufacturing, supplying, storing or dealing in any article or commodity that may be a subject of trade or commerce,*
>
> *(b) restrain or injure, unduly, trade or commerce in relation to any such article or commodity,*
>
> *(c) prevent, limit or lessen, unduly, the manufacture or production of any such article or commodity or unreasonably enhance the price thereof, or*
>
> *(d) prevent or lessen, unduly, competition in the production, manufacture, purchase, barter, sale, transportation or supply of any such article or commodity,*
>
> *the Federal Court may make one or more of the orders referred to in subsection (2) in the circumstances described in that subsection.*

---

[14] Section 111 and 113 of the *Competition Act*.

[15] Section 123 of the *Competition Act*

> *(2) The Federal Court, on an information exhibited by the Attorney General of Canada, may, for the purpose of preventing any use in the manner defined in subsection (1) of the exclusive rights and privileges conferred by any patents for invention, trade-marks, copyrights or registered integrated circuit topographies relating to or affecting the manufacture, use or sale of any article or commodity that may be a subject of trade or commerce, make one or more of the following orders:*
> *(a) declaring void, in whole or in part, any agreement, arrangement or licence relating to that use;*
> *(b) restraining any person from carrying out or exercising any or all of the terms or provisions of the agreement, arrangement or licence;*
> *(c) directing the grant of licences under any such patent, copyright or registered integrated circuit topography to such persons and on such terms and conditions as the court may deem proper or, if the grant and other remedies under this section would appear insufficient to prevent that use, revoking the patent;*
> *(d) directing that the registration of a trade-mark in the register of trade-marks or the registration of an integrated circuit topography in the register of topographies be expunged or amended; and*
> *(e) directing that such other acts be done or omitted as the Court may deem necessary to prevent any such use."*

There are a number of different acquisitions of property that may raise concerns under subsection 32(1) of the *Competition Act*. These include[16]:

1. When a firm with a dominant market position acquires the intellectual property rights of the only commercially viable alternative product;
2. when a firm acquires exclusive rights to use a complementary technology or product that allows the firm to leverage its market power into a related market;
3. when a firm obtains rights in future intellectual property developed independently by others (e.g. a "grant back" clause); and
4. a dominant firm acquires exclusive rights to improvements on its own technologies or products that have been developed by others.

---

[16] Donald Cameron and Iain Scott, Competition Law for the 21st Century, (Juris Publishing, 1998) at p.343-344.

Similar to the U.S. the time of assessing a potentially anti-competitive act is the time of acquisition of the intellectual property.

On September 21st, 2000 the Bureau announced the coming into force of the *Intellectual Property Enforcement Guidelines* (hereinafter the "IP Guidelines"). The Bureau announced that its objective in publishing the IP Guidelines was to explain how the Bureau would deal with competition issues involving intellectual property and what behaviour would be susceptible to attracting the Bureau's attention as being actionable in light of the *Competition Act*. Notwithstanding that the IP Guidelines are not law, they are an instrument which provides the public with an indication of how the Bureau will apply the law in connection with commercial practices involving intellectual property.

The main objective in the publication of the IP Guidelines is to achieve a certain uniformity in the procedures adopted by the Bureau and this objective, some believe, if attained, would contribute to the development and furtherance of competition law in Canada. In its evaluation, the Bureau begins with the principle that the exercise by the owner of his intellectual property rights is not in and of itself anti-competitive and then follows the procedure prescribed in the IP Guidelines to verify that the *Competition Act* has not been breached.

The IP Guidelines are divided into seven parts, and part 4 describes the procedure to be used by the Bureau. In summary, the Bureau proceeds using a 5 step analysis: (i) determining the nature of the transaction; (ii) determining the relevant market; (iii) determining whether the enterprises involved possess market power; (iv) verifying whether the transaction unduly impedes or reduces competition; and (v) verifying the existence of any motives which may be based on efficiency. Following this analysis, the Bureau then decides if there are sufficient grounds to intervene and to apply the remedial powers available to it by virtue of the *Competition Act's* criminal and civil provisions, for example, penal sanctions or the use of special remedies which permit, amongst others, the cancellation of a contract, the revocation of a patent or the expungement of a trade-mark, or even the compulsory grant of licences. However, the IP Guidelines state that the Bureau will only use those special powers on rare occasions and only when other recourses are not available pursuant to the intellectual property law in question.

A problem to be noted with the IP Guidelines is that an analysis by the Bureau of a commercial transaction, using the criteria defined above, involving intellectual property can be long, expensive and complex. Because of this, it will often be difficult to evaluate whether or not it would be prudent to wait for the Bureau to finish its analysis before closing a transaction.

Even though the publication of the IP Guidelines can be of assistance in foreseeing the type of behavior which the Bureau could find offensive and trigger application of the *Competition Act*, it also gives rise to a number of questions, some novel, and there will always be an element of subjectivity in the exercise of the discretion of the Bureau to initiate any kind of procedure against a party under the provisions of the *Competition Act*. One thing is certain: it is important to take into account anti-competitive implications in all commercial transactions involving intellectual property, including for example, licences and partnership agreements.

4. Intellectual Property in Due Diligence Audits

Regardless of the transaction, whether it is a merger, sale or acquisition, the parties to the transaction are bound by the contracts prepared by their respective legal representatives. Therefore, it is essential that a party to a transaction master the contents of its contracts, the risks involved with the transaction contemplated, so it can readily assess the extent of its rights and obligations. It is equally important that the other party to the transaction carefully reviews these contracts to asses the risks involved with the transaction contemplated.One of the main objectives of carrying out a due diligence audit of intellectual property is to understand exactly what is being transferred.

By their nature, many types of intellectual property owe their existence to the law and a legal threat could mean complete loss of ownership or availability to use a particular asset, which may be fundamental to the business concerned[17].
Proper searching and evaluation of the results can ensure that the costs associated with obtaining the rights are as economical as possible and the rights are obtained as rapidly as possible.[18]

4.1 Patents

Canadian patents are awarded to applicants who file patent applications for an invention as defined in section 2 of the *Patent Act*[19]. An invention is "any new and useful art, process, machine, manufacture or composition of matter,

---

[17] Adrian Smith, *Intellectual Property and Managing Legal Risk*, Patent World November 1997 at p.2528.
[18] Joan Van Zant, *Due Diligence Searching…Searching…Searching…Prior Art and Prior Rights* (Toronto: Scott & Aylen).
[19] *Supra,* note 1.

or any new and useful improvement in any art, process, machine, manufacture or composition of matter". Non-statutory subject-matter for patents include methods of surgical treatment, mathematical algorithms, laws of nature and software *per se*. However, if the invention includes software, but is framed in terms of a system that forms traditional subject-matter, a patent can be granted.

Any inventor or his legal representative may apply for a patent with respect to any invention. A patent is awarded to the first person who files the patent application. Furthermore, to maintain the requirement of novelty, the application must be filed prior to any third party disclosing the invention to the public in Canada or elsewhere.

Methods of doing business have traditionally been held to be unpatentable, as have rules of playing a game or any other invention that relies on mental abilities. Higher life forms, such as mice, are patentable, until the Supreme Court rules otherwise[20].

In order for a valid patent to be granted in Canada, requirements of novelty, utility and non-obviousness must have been met. The requirement of novelty is absolute novelty except that Canada provides a grace period to inventors to disclose their invention and file a valid application up to one year after having publicly disclosed the invention. This grace period also extends to people who directly or indirectly obtained such knowledge from the inventor.

The term of a patent is 20 years from the filing date, which cannot be extended, provided annual maintenance fees are paid to maintain the patent application or patent in force. However, for patents issued before October 1, 1989, or stemming from applications filed before October 1, 1989, the term of these patents is 17 years from the date of issue.

Certain patents based on applications filed before October 1, 1989 that have not yet expired may benefit from up to an additional three years of patent protection, because of an amendment to the *Patent Act* (introduced as Senate Bill S-17) intended to bring the term of patent protection in line with Canada's obligations under the World Trade Organization TRIPS agreement[21]. Under the proposed new Section 45, a patent would expire on whichever is the later between 17 years after the date of issue or 20 years after the date of

---

[20] See *Harvard College* v*. Canada (Commissionner of Patents)*, 7 C.P.R. 4th 1.

[21] See article 33 of the *Agreement on Trade-Related Aspects of Intellectual Property Rights*, Annex 1C of the *Marrakesh Agreement Establishing the World Trade Organization*, signed in Marrakesh, Morocco on 15 April 1994. http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm

filing. As a result, licensees should be reviewing their licence agreements to determine whether they will be required to pay royalties for an extended period of time. Companies or individuals who are planning to manufacture, use or sell products that are subject to third-party patents on the basis that those patents are about to expire will need to be especially vigilant in determining the correct expiry dates of the relevant patents[22].

The grant of a patent confers on the holder the exclusive right, privilege and liberty of making, constructing and using the invention and selling it to others to be used. Although stated positively, this is in fact a negative right in that the right granted by the patent is the right to prevent a third party from practising the invention.

Patents can be granted on improvements, but the owner of the patent on the improvement does not thereby obtain the right of making, selling or using the original invention, nor does the patent for the original invention confer to its owner the right of making, selling or using the patented improvement.

Canadian patent applications can claim priority of foreign applications of countries members of the Paris Convention[23] provided such claim to priorities are made within 16 months from the priority date.

Canadian applications are published 18 months after the filing date or the priority date if there is one. Canadian patent applications are not automatically examined. A request for examination must be filed within 5 years of the filing date, otherwise, the application becomes abandoned.

4.1.1 Co-ownership of Patents

Legislative Jurisdiction

The rights of co-ownership in relation to a patent are not addressed in the Canadian *Patent Act*. We are therefore required to revert to alternative applicable legislation. Given that "Property and civil rights" fall under the jurisdiction of the provinces pursuant to section 92(13) of the Canadian

---

[22] Michener, Lang. *Bill Introduces Additional Retroactive Patent Protection*. International Law Office Newsletter, April 2 2001. http://www.internationallawoffice.com/Ld.cfm?Newsletters__Ref=3258 .

[23] *Paris Convention For The Protection Of Industrial Property*, (March 20, 1883), as revised at Brussels on December 14, 1900, at Washington on June 2, 1911, at the Hague on November 6, 1925, at London on June 2, 1934, at Lisbon on October 31, 1958, and at Stockholm on July 14, 1967.

Constitution of 1867[24], the rights and obligations of co-ownership are dictated by provincial laws. That is to say that once a patent is awarded, particular questions as to property rights vested in the patented matter are regulated by civil law, and therefore are under provincial jurisdiction.

The issue of co-ownership of patents is more complex in Canada than elsewhere due to the duality in legislation that exists between Common Law provinces and the province of Quebec, where the civil law may give rise to results that differ from other provinces.

Unfortunately, in Canada, there are very few decisions that address the co-ownership of a patent. Even the Common Law provinces, which traditionally have reached decisions based on jurisprudence from the United Kingdom, are finding themselves being influenced more and more by decisions emanating from the United States. As a result, we find in Canada a number of diverging solutions to the issues of co-ownership of patents emanating from different jurisdictions.

The Patent Act

The only section of the *Patent Act* that refers to joint or collective patent applications is found at section 31. Generally, subsection 31(1) contemplates situations where an invention is made by two or more inventors and one of them refuses to make application for a patent or his whereabouts cannot be ascertained after diligent inquiry. The other inventors or their legal representatives may make application, and a patent may be granted in the name of the inventors who make the application, on satisfying the Commissioner that the joint inventor has refused to make application or that his whereabouts cannot be ascertained after diligent inquiry.

Although in the United States the courts have tended to invalidate a patent where it was clearly revealed that all of the true inventors had not been identified[25], in Canada, the jurisprudence in this area has not been well established. The courts appear more concerned with the effects that may arise from an erroneous identification of an inventor on the ownership of the patent and avoid the annulment of the patent when another solution is available[26].

---

[24] *Constitution Act of 1867*, 30 and 31 Vict., U.K., c.3, Section 92(13).
[25] *Pointer* v. *Six Wheel Corp.* (1949) 177 F. (2d) 153.
[26] *Piper* v. *Piper* (1904) 3 O.W.R. 451 (O.C.A.); Harold G. Fox, "Canadian Patent Law and Practice", 4th ed., (Toronto: Carswell, 1969), at p. 229.

Joint Holding of a Patent

Pursuant to paragraph 31(5) of the *Patent Act*, a patent is awarded in the name of all the applicants. Therefore, co-applicants are co-owners of the awarded patent. If a person who is not an inventor is included by error in the application, he will retain co-ownership in the patent, holding the same title as the other inventors with all the rights of use attached. Similarly, an inventor who is omitted from the application will have no rights in the patent.

When the parties proceed with a joint application and there is no contract that determines the rights of each in an awarded patent, the patent is granted conjointly to all the parties[27]. Ownership rights in a patent, therefore, may be the result of silence.

Co-ownership of a patent may also be the result of an express clause in a contract which provides that any technology developed remains jointly owned by all parties. However, such contractual clauses foreseeing joint title to the rights in a technology are often the source of problems that must be resolved at some point in the future, either through further agreements, arbitration or the courts. Most contracts foreseeing joint ownership of a patent do not stipulate the legal consequences of such a joint ownership. Contracts that create a joint ownership should specify the rights and obligations regarding the grant of a patent, its maintenance, use, and the rights conferred to co-patentees[28].

The Co-inventors Portion

At common law, since a patent is awarded to all co-applicants and no provision of the *Patent Act* specifies in what proportion the patent is awarded to each, it appears that the co-patentees can claim equal rights in the patent.
In Quebec, in the absence of an agreement between the parties, the *Civil Code of Quebec* provides that the shares of undivided co-owners are presumed equal.[29] Co-ownership is said to be undivided when the property rights are not accompanied by a literal division of the property. By analogy, co-ownership of a patent is also undivided given that it is impossible to literally divide a patent. It follows that each undivided co-owner has the rights and

---

[27] Paragraph 31(5) the *Patent Act.*
[28] D. Patrick O'Reilly "Joint Ownership of Patents in the United States", article adapted from chapter 1 of "Drafting Patent LicenceAgreements", 4th edition, (Washington, Bureau of National Affairs, 1998).
[29] Article 1015 C.C.Q.

obligations of an exclusive owner as regards to his share. Thus, each may alienate or hypothecate his share and his creditors may seize it.

The Right to Use the Invention

Is a co-patentee obliged to obtain the consent of the other co-patentees prior to exploiting the patented technology? In the affirmative, a particular co-patentee would have the power to hinder the other co-patentees from exploiting the patent and could completely prohibit the use of the patented invention.

Until 1978, most Canadian decisions regarding co-ownership of a patent followed British jurisprudence[30] which indicated that a co-patentee may use an invention without the consent of his co-patentees and for his own benefit.

In 1978, Justice Mayrand of the Quebec Court of Appeal in *Marchand* v. *Péloquin*,[31], rendered an opinion which proved incompatible with the British decisions and in doing so stated the following:

> Canadian law does not refer to the right of each of the co-patentees to grant a licence without the consent of the other co-patentees, nor on his right to exploit the patent for his own profit. To determine the rights of a co-patentee, our courts are at liberty to return to their own interpretative norms and foreign decisions relative to the same or similar laws can only serve as an authority for a logical argument.

This case applies equally to the rights of co-patentees to exploit the patent and the obligation to render an account of this exploitation to their co-patentees. In the opinion of Justice Mayrand, co-patentees hold indivisible rights that are preferably exercised together, for the benefit of all co-patentees, in a manner similar to that of co-authors of a literary work or co-owners of corporeal property. The Court arrives at the conclusion that a patentee cannot exploit the invention for his own gain without the consent of his co-patentees to whom he owes a duty to render account.

Justice Mayrand's decision was certainly inspired by principles of indivision drawn from Quebec civil law. This could be the reason why common law courts did not follow the reasoning of this single Canadian decision, but rather returned to the reasoning of English jurisprudence. In fact, in 1995, in *Forget* v.

---

[30] See *Mathers* v. *Green*, (1865), 35 L.J. Ch. 1 (Chan. Div.) and *Steers* v. *Roger*, (1893) A.C. 232 (H.L.).

[31] *Marchand* v. *Péloquin,* (1978), 45 C.P.R. (2d) 48 (Q.C.A..), at p. 60.

Specialty Tools of Canada, Inc.[32] Justice Wood of the Court of Appeal of British Columbia stated that the obligation to obtain the consent of the co-patentee and to share the profits resulting from the use of the patent was incompatible with the right of each co-patentee to exploit the invention as foreseen by section 42 of the *Patent Act*. Justice Wood thereby concluded that a patent is not infringed when a co-patentee manufactures or sells the invention within Canada without the consent of his co-patentees. The question of profits was not addressed by the Court of Appeal in this decision. Nevertheless, given that it was based on an English decision where it was found that sharing of profits was not required in the absence of an agreement between the parties,[33] one may predict that the Court would have chosen to follow this reasoning.

4.1.2 Assignment of Patents

Once the patent has been awarded it is considered property and is susceptible of being sold, assigned or otherwise alienated in a manner similar to other types of intangible property. However, section 50 of the *Patent Act* provides certain requirements concerning the assignment or licensing of an exclusive right to use a patent which are pertinent to any related due diligence.

Firstly, any such assignment must be made in writing. Additionally, for any such assignment to be opposable to third parties it must be registered with the Canadian Patent Office[34]. This also applies to the grant of an exclusive licence to use the patent[35].

Therefore, during any due diligence it is imperative to locate and identify the inventor or inventors to ensure the validity of the chain of title between the inventor and the assignee. It may be necessary to verify the contents of any employment contracts to ensure that the inventors have assigned all the rights in any inventions to their employer. When dealing with universities or other research centres, an investigation of any co-development contract is important in order to identify any remaining rights in the technology.

---

[32] *Forget* v. *Specialty Tools of Canada Inc.* (1996), 62 C.P.R. (3d) 537 (B.C.C.A.) (hereinafter *Forget*).
[33] *Mathers* v. *Green, supra* note 30.
[34] S.50(3) & 51 *Patent Act*. (Section 51 of the *Patent Act* states that any assignment is void against any subsequent assignee unless the assignment or licence is registered as prescribed before registration of the instrument on which the subsequent assignee claims.) *Canadian Patent Office*, http://strategis.ic.gc.ca/sc_mrksv/cipo/contact/t_list-e.html#patent.
[35] S.50(2) *Patent Act*.

When faced with the rights of one or more co-patentees, can a patentee assign a portion of his interest without the consent of the co-patentees? The answer to this question varies according to two hypotheses which were raised in *Forget*:[36] (1) the assignment by a co-patentee of all his interest in the patent and (2) the assignment by a co-patentee of a portion of his interest in the patent.

At common law, in the first case, the B.C. Court of Appeal considered that a co-patentee who transferred all his rights in a patent to an assignee did not dilute the rights of the co-patentees. The assignee is simply substituted for the assignor and there is no impact on the rights of the co-patentees who continue to share the patent with another person. The Court went on to conclude that the consent of the co-patentee was unnecessary in such a case. In the second case, if the assignor decides to assign a portion of his rights to one or more persons, the co-patentee of the assignor finds himself in undivided co-ownership with an increasing number of co-patentees and a corresponding dilution of his rights. The consent of the co-patentee is therefore required in such cases to guarantee that the essential characteristics of the patent, i.e. exclusivity, are maintained.

At civil law however, article 1022 of the *Civil Code of Quebec* reveals an important restriction on the right of a co-owner to assign his rights by conferring a right of redemption to the other undivided co-owners. By analogy, all co-patentees who learn that a third party has acquired, by onerous title, the share of a co-patentee, may, within 60 days of learning of the acquisition, exclude this third party from the indivision by reimbursing him the transfer price and the expenses incurred. However, it should be noted that the right of redemption must be exercised within one year from the date of the assignment.[37]

It should also be noted that, although the undivided portion in a patent may be hypothecated[38], this right to hypothecate is subject to the same rights of redemption in the case where a secured creditor considers selling the share or to take it in payment.[39]

3.1.3 Research at the Patent Office

[36] *Forget*, *supra* note 32.
[37] Article 1022 C.C.Q.
[38] Article 1015(2) C.C.Q.
[39] Article 1023 C.C.Q.

The Canadian Patent Office[40] allows for several types of searches[41], the most common being an index search using the name of the enterprise being acquired. Searching this index allows patents granted to the enterprise to be identified, as well as applications for patents that have been filed and are pending. The purchaser may also carry out a search on any assignments or licences granted by the enterprise. The *Patent Act* requires that all assignments or grants of exclusive licences be registered with the Patent Office in order to be made opposable to subsequent assignees. Further searches may be carried out to identify security interests that burden a patent or patent application.

Section 11 of the *Patent Act* also enables one to determine through the Patent Office if an application for a patent is pending in Canada upon providing the name of the inventor if available, the title of the invention and the number and date of a patent said to have been granted in a named country other than Canada.

A validity search attempts to find patents or publications that may affect the validity of claims of a patent because they would tend to make the invention obvious or anticipated. Since the scope of such search is very broad, its results will likely include patents that were not found by the Patent Office examiner in the course of the application process.

The infringement search is meant to locate claims (including product claims method and apparatus claims) in patents or patent applications that may be infringed by the commercial activities of the target company. The fact that any such process or method is patented by the target does not mean that it does not infringe on other patents, since a patent does not grant the right to do something specific, but rather the right to prevent others from doing the same.
These types of searches are of particular importance in the case where the target company's success or viability depend on the fact that its products do not infringe on others' patent rights.

3.2 Trade-marks

3.2.1 Introduction

---

[40] *Surpa*, note 34.
[41] Canadian Patent Database, http://patents1.ic.gc.ca/intro-e.html

A trade-mark is a word, symbol or shape (or a combination of them) used to distinguish the goods or services of a person from those of others. Trade-marks may not be used in a way that would confuse the public. Confusion may arise if a trade-mark is used in a manner that may lead to the inference that the goods or services associated with such trade-mark are in the same general class as the goods or services associated with a confusing trade-mark.

3.2.2 Rights through Use

There is no requirement to register a trade-mark in Canada. The use made of a trade-mark in a specific region will enable its owner to protect its market and prevent other businesses from using a trade-mark that is identical or that is likely to be confusingly similar to this trade-mark. The owner of a trade-mark therefore acquires certain rights merely through the use of the mark. However, an unregistered mark is likely to be geographically limited in scope. A registered mark, on the other hand, provides the holder with an exclusive right to use the mark throughout Canada, as long as the registration is maintained, along with a number of other advantages described hereafter.

In Canada, common law and civil law (in Quebec) rights in a trade-mark exist in addition to the rights provided by the *Trade-marks Act*[42]. The statutory jurisdiction over trade-marks is federal, while the jurisdiction of passing off is provincial, on the basis of authority of the provinces over "Property and civil rights"[43]. Trade-mark owners often use the common law action of passing off to restrain the activities of others. Such action may be coupled with an action for trade-mark infringement under the Trade-Marks Act, or brought separately where a statutory cause of action does not exist.

3.2.3 Registration

As mentioned earlier, it is not necessary to register a trade-mark under the *Trade-marks Act* in order to obtain enforceable trade-mark rights. However there are many advantages in registering a mark. It confers an exclusive right to use the trade-mark throughout Canada. It creates two statutory causes of action: (1) Action for passing off; (2) Action for trade-mark infringement and for depreciation of the goodwill attaching to the registered trade-mark pursuant to the Paris Convention[44]. Also, the applicant may rely on a priority

---

[42] *Trade-marks Act*, R.S.C. 1985, c. T-13. http://laws.justice.gc.ca/en/T-13/index.html
[43] See section 92(11) *Constitution Act*, 1867. http://laws.justice.gc.ca/en/const/index.html
[44] *Supra,* note 23.

filing date in Canada as its filing date in a foreign country (if application is filed within 6 months of the application in Canada). The *Trade-marks Act* also provides that the exclusive rights of a trade-mark owner are deemed infringed by a person who sells, distributes, or advertises wares or services in association with a confusing trade-mark or trade name.

Until recently, it was only possible to register a licensee as a user of a trade-mark if the trade-mark was registered. That requirement has since been eliminated by the amendment to the *Trade-Marks Act* abolishing the registered user system[45].

3.2.4 Application for Registration

In general, an application for the registration of a trade-mark in Canada can be based, namely, on any of the following: (i) use of the trade-mark in Canada by the applicant (or its predecessor in title or its licensee), (ii) making-known the trade-mark in Canada by the applicant (or its predecessor in title) so the trade-mark becomes well-known in Canada, (iii) corresponding registration (or application) in a Paris Convention country and (iv) use anywhere in the world or (v) intent to use the trade-mark in Canada by the applicant (or a licensee).

There is a period of approximately twenty (20) to twenty-four (24) months between the filing of an application and the issuance of the registration.

Once the application for registration is filed, a first step consists in the review by an examiner of the Trade-marks Office of the application for registration of a trade-mark. The role of the examiner is to make sure of the registrability and compliance with trade-mark law and practice. A trade-mark can be registered if it is not primarily merely a family name, clearly descriptive or deceptively misdescriptive, in French or English, of the wares or services and the name in any language of the wares or services. Also, the trade-mark has to be distinctive and must not create confusion with a trade-mark or trade name previously registered, made known or used in Canada.

If the trade-mark seems to be registrable to the examiner, it is published in the weekly Trade-marks Journal. Any interested party may seek to oppose the application within two (2) months of the date of publication of the applicable Trade-marks Journal. Such opposition is carried out before the Trade-marks Opposition Board where the opponent files a statement of opposition setting out its objections.

[45] S.C. 1993 c. 15, section 69 and section 50.

3.2.5 Term of protection

Registration of a trade-mark in Canada is valid for consecutive fifteen (15) year terms. As the terms may be renewed any number of times, the protection afforded by registration may be of an infinite length. In certain situations it may prove of interest to trade-mark owners to take advantage of the provisions of the *Criminal Code* with respect to the protection of trade-mark rights[46].

3.2.6 Limits on Trade-mark Enforcement

Some limits to the validity of a registered trade-mark are defects in registration, adverse changes in the distinctiveness of the trade-mark, loss of distinctiveness or failure to use the trade-mark.

3.2.7 Review of Marking in Association with Trade-marks

The *Trade-marks Act* does not contain any section requiring that marking be used in association with trade-marks. However, it has been recommended that trade-marks be properly marked whether they be registered or simply adopted. Marking is especially important when a trade-mark is used under licence.

Five symbols may be used for marking purposes:

- ® : Should be used when the trade-mark is duly registered;
- ™ : Should be used when the trade-mark is adopted (used without registration) or has been filed for registration with the Trade-Marks Office;
- * : Used when a trade-mark is adopted (used without registration);
- md : Used in the French language only. Means that the trade-mark is registered (marque déposée);
- mc : Used in the French language only. Means that the trade-mark is adopted (used without registration) or has been filed for registration with the Trade-Marks Office (marque de commerce).

These symbols should appear to the right of the trade-mark and must refer to a legend describing which entity is the owner of the trade-mark:

---

[46] See section 406 and following of the Canadian *Criminal Code*, L.R.C. 1985, ch. C-46.

- "Registered trade-mark of (name of owner)"; or
- "Registered by or (name of owner)"; or
- "A trade-mark of (name of owner)".

The trade-mark associated with the products or services sold or offered in Canada must, by application of the *Consumer Packaging and Labelling Act*[47], be identified in the two official languages, English and French. In the French language, the legend should therefore read as follows:

- "Marque de commerce enregistrée de (name of owner)"; or
- "Enregistrée par (name of owner)"; or
- "Marque de commerce de (name of owner)".

The ® symbol can be used **only if a trade-mark is registered**. If the products and/or services are exported or offered in the United-States, the ® symbol can be used only if the owner of the trade-mark has a duly registered trade-mark in the United-States. If it is not the case, the following symbols must be used: ™ or *.

If the trade-mark is used under licence, the following legend should be associated with the trade-mark by application of section 50 of the *Trade-Mark Act*:

- "Trade-mark of (name of owner) used under licence by (name of licensee)"; or
- "Registered trade-mark used under licence by (name of licensee)"; or
- "A trade-mark used under licence by (name of licensee)".

3.2.8 Assignment of Trade-marks

Trade-marks may also be sold like any other property. However, if the trade-mark is registered, the sale must also be registered with the Trade-marks Office. A trade-mark may be licensed or franchised through an agreement by and between the interested parties. However, to ensure that a trade-mark does not lose its distinctiveness, the owner of the mark must, by contract, maintain control over (i) the characteristics and the quality of the merchandise or services offered in connection with the trade-mark, (ii) the use of the trade-mark, and (iii) the advertisement or the display of the trade-mark. The owner must also in fact ascertain these rights to maintain the distinctiveness of the trade-mark.

---

[47] *Consumer Packaging and Labelling Act*, (R.S. 1985, c. C-38). http://lois.justice.gc.ca/en/C-38/32545.html

In the case of a sale of a trade-mark, the parties must prepare an assignment document indicating the change of ownership of the trade-mark. The Registrar, on being furnished with evidence satisfactory to him of the transfer will then, by virtue of subsection 48(3) of the *Trade-marks Act*, register such transfer.

3.2.9 Research at the Trade-marks Office

Trade-marks in Canada may be registered with the Trade-marks Office[48]. As stated above, registration of a mark with the Trade-marks Office provides the holder with an exclusive right to use the mark throughout Canada as long as the registration is maintained, along with a number of other advantages.

Similar to patents, a number of searches[49] may be carried out at the Trade-marks Office: (i) An index search may be conducted as a first step in a commercial transaction; this type of search is made to determine trade-mark registrations and pending applications for registrations recorded in the name of a person; (ii) a registered user search of the records permits to point out instances in which third parties had been authorized to use a particular trade-mark or if the company had been licensed to use trade-marks of third parties prior to the amendments to the *Trade-marks Act* abolishing the authorized user registration obligation; (iii) an opposition search may also be done in order to see if opposition applications are pending. It is also possible to verify documentation relating to security interests recorded against a trade-mark registration or application. This type of search is not always reliable since the information is not recorded against title; therefore, it is important to review the file history.

However, it should be noted that, as there is no requirement to register a trade-mark, it is likely that any search at the Trade-marks Office will be incomplete. Additional searches outside of the Trade-marks Office may be necessary to provide a more complete picture.

3.3 Copyright

Copyright is the protection of the expression of creativity that can be a literary, artistic, musical or dramatic work. Upon the creation of an original work that is fixed intangible form, copyright occurs automatically and the

---

[48] Trade-mark Office; http://strategis.ic.gc.ca/sc_mrksv/cipo/tm/tm_main-e.html

[49] Canadian Trade-mark Database, http://strategis.ic.gc.ca/cgi-bin/sc_consu/trade-marks/search_e.pl

benefits of a certain protection arises, giving its creator different rights. Neither notice nor registration is needed to automatically extend copyright protection in Canada as it is the case in many other countries of the world. Therefore, very few businesses register copyright, unless the work is valuable. The essential concept of copyright is that there is no protection for the ideas or concepts themselves, only for their expression.

In Canada, copyright is a statutory right that exists solely under the *Copyright Act*[50]. The federal parliament has exclusive jurisdiction over copyright. However, provincial law will apply as suppletive law with respect to the sale, transfer, lease or licence of copyrights as such transactions fall under the provincial jurisdiction of "Property and civil rights"[51].

3.3.1 Rights

Simply put, copyright means the sole right to produce a work or any substantial part thereof in any material form whatsoever. It also includes the sole right to perform the work or any substantial part thereof in public, to produce, reproduce, perform or publish any translation of the work. In the case of a literary, dramatic or musical work, it includes the right to make any sound recording, cinematographic film or other contrivance by means of which the work may be mechanically reproduced or performed or in the case of computer programs, the sole right to license the computer program.

In addition, the copyright holder has the sole right to authorize the commission of the above acts. The sole right to authorize these acts is a separate and substantive right which means that the copyright owner is not the only person entitled to reproduce the entire work or any substantial part thereof, but also the only person that can properly authorize a third party to produce or reproduce the entire work or any substantial part thereof.

3.3.2 Term of protection

In general, copyright subsists upon creation of the work for the life of the including up to the end of the year in which the author dies (because copyright protection always ends on the last year of protection) plus fifty (50) years.

---

[50] *Supra*, note 2.
[51] *Supra*, note 43

In the case of more than one author (joint authors), the term of protection of copyright in the work is the life of the author who dies last including up to the end of the year in which he dies plus fifty (50) years.

In the case of an unknown author the term of protection of the copyright will be the earlier of either (i) the end of the year of first publication plus fifty years or (ii) the end of the year of the making of the work plus seventy five (75) years.

When the author dies, in the case of an unpublished work, it depends on the date of death of the author. If the author died after January 1st, 1999, the term of protection of the copyright will be the end of the year of first publication, public performance, or communication plus fifty (50) years. If the author died before January 1st, 1999, the term of protection of the copyright will be the end of the year in which the author died plus fifty (50) years.

If the author of a work died before September 1st, 1949, the term of copyright protection will be five (5) years following December 31st, 1999, independently of any publication, public performance or communication. In other words, every work for which the author died before September 1st, 1949 will become public and will no longer benefit from copyright after December 31st, 2004.

In the case of photographs the term of copyright protection will be the remainder of the year of the making of the initial negative or plate of the initial photograph plus fifty (50) years.

Where the copyright belongs to her majesty, the term of protection will be the end of the year of the first publication of the work plus fifty (50) years.

In the case of joint authorship where authors are nationals of any country, other than a country that is party of the North American Free Trade Agreement, the term of protection will be the shorter term of protection granted among the different systems.

For cinematographic works in which the arrangement or acting form or the combination of incidents represented give the work a dramatic character, the term will subsist for the same period as for a dramatic work. In the other cases, the copyright protection will subsist:

- if published, the end of the year in which the work was first published plus fifty (50) years;
- if not published, the end of the year of its creation plus fifty years (if still not published).

3.3.3 Registration

There is no formal requirement to confirm the existence of a copyright by registration. However, Canada has a registration system which has the advantage of providing the holder of a registration certificate with a number of presumptions in his favor, including presumptions as to (i) the validity of the copyright subsisting in the work, (ii) the ownership of the copyright by the registered owner, and (iii) the knowledge on behalf of third parties of the subsistence of copyright in a given work. Absence of registration does not preclude the copyright owner from filing an action into court.

The owner can obtain registration by submitting at the copyright office, an application filed in a specific form with payment of the prescribed fees. There is no examination and no requirement to file a copy of the work.

3.3.4 Ownership

Except in specific circumstances, the author of a work is presumed the first owner of the copyright subsisting in a work. The most important exception to this rule is the case of a work "made in the course of employment". Where a work is made in the course of employment or apprenticeship the person by whom the author was employed retains title as first owner unless a written agreement to the contrary exists between the parties. It should be noted that this concept of "made in the course of employment" does not extend to consultants or independent contractors. Apart from this particular case, however, the ownership of copyright remains with the first author of a work until such time as it is assigned in writing.

3.3.5 Limits

Copyright prohibits the reproduction of an original work. It does not however prohibit the independent creation of a similar work. This complicates enormously any verification carried out in due diligence. It is suggested, therefore, to insist that the assignor remain responsible if it later comes to light that the works in question are in fact infringing copyright of a third party.

3.3.6 Due Diligence

The first step in any due diligence related to copyright is to examine the chain of title of the works in question to ensure that the vendor possesses the right of ownership. The *Copyright Act* confers the right of ownership in the work to the titulary of the work from the moment of its creation. In fact, any registration of copyright confers only a rebuttable presumption of ownership. Of note is subsection 13(3) of the *Copyright Act*, which creates, as seen above, a presumption, in absence of an agreement to the contrary, that ownership in works created by an employee during his employment are the property of the employer. However, an important deviation from this principle applies in the case of consultants who are hired from time to time by an enterprise. In the absence of an agreement to the contrary there is a presumption that the rights in any works created during the course of the agreement are vested in the consultant and not the employer.

3.3.7 Assignment of Copyright

Assignment of copyright provides another exception to common law or civil law (in Quebec) by requiring a written document signed by the assignor attesting to the assignment of copyright. As copyright is not subject to any formal requirements of registration, neither is the assignment of copyright. However, it is recommended to register any and all rights in a work and to register any assignment during the acquisition of an enterprise. An assignee may find his assignment declared null in the face of a third party in good faith who acquired the rights in the work for value and who registered the assignment prior to the registration of that of the assignee[52].

In the event of a silent agreement as to the transfer of copyright in a work, the transfer of copyright will generally not be implied. However, a general clause regarding the assignment of all the intellectual property rights necessary to operate a corporation would normally include copyright. Furthermore, the transfer of a physical object does not imply the transfer of its copyright.

3.3.8 Insolvency

---

[52] Subsection 57(3) of the Copyright Act.

The *Bankruptcy and Insolvency Act*[53] specifies at section 83 that in the case of insolvency of the assignee, all assigned copyrights or interests in a copyright automatically return to the author. However, the work must not have caused expenses or been published, if so, the *Copyright Act* specifies repurchase terms in favor of the author. It is important to note that any agreement to the contrary entered into with a bankrupt is null and void.

3.3.9 Moral Rights

The *Copyright Act* also creates moral rights in a work which benefit only the author. Moral rights relate to the right to the integrity of the work and the right to paternity in respect of the work. In essence, moral rights in a work may restrict the modification or exploitation of a work after it has been sold or licensed by enabling the author to prohibit an assignee from defacing the work and to reclaim the work under certain circumstances. An author's right in the integrity of a work is only infringed where the work is, to the detriment of the honor or the reputation of the author, either distorted, mutilated or otherwise modified, or used in association with a product, service, cause or institution.[54] This may prove important when modifying a given software for instance. Note that moral rights extend also to the use of a pseudonym and even the right to remain anonymous.

Moral rights cannot be assigned but the *Copyright Act* foresees that an author can renounce to his moral rights in a work. This renunciation may have the same or different terms than the assignment. In any case, it is recommended to ensure that the owner of the rights in the work also obtain a clear renunciation by the author of his moral rights in the work. In the absence of such waiver in the assignment agreement, it is recommended to have the vendor sign an agreement to obtain such a renunciation.

3.3.10 Research at the Copyright Office

A number of different types of searches can be carried out at the Copyright Office. The index search may be used to locate the copyright registered by name and may determine what copyright has been granted or transferred. A title search may be used to reveal any licences and security interests that affect the copyright in a work.

---

[53] R.S.C. 1985, c. B-3. http://laws.justice.gc.ca/en/B-3/index.html
[54] Sheldon Burshtein, *Intellectual Property Due Diligence in Commercial Transactions* (1994), 11 CIPR 91 at p.120.

As for the limits of such searches, in practice, searches carried out in the Copyright Office provide only little information, since the majority of copyrights are not registered, with the exception of enterprises whose activities rely greatly on the protection afforded by copyright.
Applications for registration are not available for searching. Also, records at the Copyright Office may contain errors that may affect reliability of the search.

3.3.11 Marking in association with Copyright

It is recommended that work distributed to the public be properly marked by indicating the familiar copyright notice: "©, (year of first publication), (name of the owner).

3.4 Trade Secrets

3.4.1 Definition of Trade Secrets

No specific legislation in Canada defines what constitutes a trade secret. A number of authors have held that a trade secret consists of information, including formulas, procedures, methods, techniques, or compounds used in the business of an enterprise which is not in the public domain and has an economic value.[55]

At common law, trade secret means information including but not limited to a formula, pattern, compilation, program, method, technique, or process, or information contained or embodied in a product device or mechanism which:

1. is, or may be used in a trade or business,
2. is not generally known in that trade or business,
3. has economic value from not being generally known, and
4. is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[56]

At civil law (in Quebec), the case of *Positron Inc. v. Desroches et al.*,[57] confirmed that the common law cases were applicable in the province of Quebec. Mr. Justice Biron went on to propose the following definition:

---

[55] Pierre Coté & Alexis Bergeron, *La proprieté intellectuelle au Quebec: financement et réalisation*, (1998) McMaster-Meighan.
[56] Institute of Law Research and Reform, Trade Secrets, Report No. 46 (Edmonton: Institute of Law Research and Reform, 1986) at 256.

> "Trade secrets are usually formulas, manufacturing processes unique to its owner and which have been revealed confidentially to an employee. This is not experience acquired by an employee but, more exactly, knowledge or know-how belonging to the employer and revealed by him for the sole purpose of permitting the employee to produce what the trade secret enables him to do. Included in this category are chemical formulas, recipes, manufacturing technologies (...)". (translated)

The notion of trade secret may be defined broadly to include know-how and confidential information, i.e. all confidential information belonging to a business that provides the holder with an economic advantage over a competitor. This information may consist of knowledge (or know-how) of a technical nature as well as client mailing lists, reports on strategic development, etc...

Given that a trade secret is, in essence, information, it implies that once a trade secret is known or discovered by someone else, there is no concrete mean by which this person may be divested of it. It also means that the fact that a trade secret is transferred to a buyer along with other intellectual property assets does not deprive the seller from its ability to use this information in the course of its business, unless contractual obligations prevent it from doing so.

The persons who benefit from trade secrets bear the risk of losing that benefit and being prevented from using the trade secret if a third party obtains a patent for the same subject-matter. When technical information is kept secret, a third party may develop the same innovation on its own and seek patent protection for it. In this scenario, the person benefiting from the trade secret could not invoke prior art or non-obviousness in order to invalidate the patent claim if the use that was made of the trade secret was not disclosed or deemed disclosed to the public. The person who was using the information without patent protection could then be precluded from using the information it developed, discovered or acquired, even if it was using it before the patent owner.

Obviously, not all information to which an employee will be exposed in the course of his work is confidential. Even when it is confidential, in many cases it will not benefit from any protection subsequent to the rupture of the employment contract in the absence of an implied duty of confidentiality (e.g. with respect to senior employees) or of a restrictive clause in the

---

[57] (1988) R.J.Q. 1636 at 1653.

employment contract or dismissal agreement. Only if the information is of a nature so confidential that it can be assimilated to a trade secret will it benefit from protection at law.

Although the requirements may vary slightly from one country to the other, the following protective measures can be considered as the main guiding principles to comply with in order to maintain a sufficient level of protection of the trade secrets of an enterprise:

1. Making sure that the information that the enterprise wants to protect as trade secret is not generally known outside the enterprise;
2. Assessing the extent to which employees and other people involved in the production of the wares or the provision of the services have knowledge of the information that the enterprise wants to protect as trade secret;
3. Maintaining and reviewing the measures that were taken to keep the information confidential on a regular basis;
4. Measuring the value of the information that the enterprise wants to protect as trade secret, both for itself and for its competitors.
5. Keeping track of the investments and efforts that were made by the enterprise during the process of developing the trade secret.
6. Evaluating the investments and efforts that would be required by a third party to obtain the information or to duplicate on its own the benefits derived from the information that the enterprise wants to protect as trade secret.

Even if these are the measures that are generally recognized by jurisprudence, they should not been considered as an exhaustive list of all the possible means to protect trade secrets

3.4.2 Enforcement of Trade Secret Rights

Trade secrets, know-how and confidential information are also considered part of the intellectual property of an enterprise. They differ however from other types of intellectual property in that they do no receive any specific legislative protection. Nevertheless, in the event that trade secrets, know-how or confidential information are illegally divulged or communicated to a third party, civil remedies may potentially be available in the form of damages and injunctions.

More specifically, in a breach of confidence case, the focus is on the loss to the plaintiff and, as in tort actions, the particular position of the plaintiff must be examined. The objective is to restore the plaintiff monetarily to the position he would have been in if no wrong had been committed and is generally achieved by an award of damages.

Of particular importance in the province of Quebec is the "Springboard Theory". This theory was expressed in *Terrapin Ltd. v. Builders Supply Co. (Hayes) Ltd.*[58]:

> "... a person who has obtained information in confidence is not allowed to use it as a springboard for activities detrimental to the person who made the confidential communication, and springboard it remains even when all the features have been published as can be ascertained by actual inspection by any member of the public... The possessor of the confidential information still has a long start over any member of the public... It is, in my view, inherent in the principle upon which the Saltzman case rests that the possessor of such information must be placed under a special disability in the field of competition to ensure that he does not get an unfair start."

When confidential information or trade secrets have leaked to a competitor, the application of the Springboard Theory will protect the "head start" held by the owner of this information and trade secrets and will "set back" those who illegally gained access to and used the information.

3.4.1 Assignment of Trade Secrets

Strictly put, a trade secret may not be sold since it is not a "property" but merely proprietary rights acquired by contract, both from a common law and civil law perspective. From a practical standpoint however, it is always possible to transfer confidential information. The transfer can be made with or without restriction upon the transferor, and in the latter case, the transferor may continue to use the trade secret. The transferee wishing to have exclusive rights must ensure by way of an agreement that the transferor will (i) maintain the confidentiality of the information and (ii) undertake not to use the trade secret so transferred.

3.4.3 Nature of the Right

The commercial advantages that an enterprise may derive from confidential information (including trade secrets) reside in its capacity to keep such information secret and prevent others to gain access to it. Therefore, such

---

[58] (1967) R.P.C. 375 at 377.

information may not be considered as property that may be sold or bought[59]. However, the holder of confidential information may acquire certain rights arising from non-disclosure agreements or from the fiduciary duties imposed, for instance, on the employees of a holder.

3.5 Industrial Designs, Integrated Circuit Topographies and Plant Breeders Rights

The *Industrial Design Act*[60] permits the registration of and results in the grant of an exclusive right in the visual and ornamental characteristics of a utilitarian product. Industrial design has a close relationship with copyright in that useful works that are considered industrial designs may also be considered artistic works and capable of copyright protection. Features of an object that are solely functional may not be the subject of an industrial registration. Registration is required to protect an industrial design; application must be filed within one year of the first sale of the design. An exclusive licence must also be registered.

Subsection 64(2) of the *Industrial Design Act* provides that where copyright subsists in a design applied to a useful article and (i) the article is reproduced in a quantity of 50 or more or (ii) the article is a plate, engraving, cast, etc. used for producing more than 50 articles, then it is no longer copyright infringement to reproduce the article. The *Industrial Design Act* counters this loss of copyright protection by awarding a 10-year period within which the registrant may maintain a monopoly right on the design in question.

The *Integrated Circuit Topography Act*[61] provides a regime of protection for the complex three-dimensional sets of electronic interconnections within a semi-conductor. Protection is only available by registering the topography and failure to file an application within two years of any commercial sale may result in the loss of rights.

Pursuant to section 3, the *Integrated Circuit Topography Act* provides for exclusive rights, upon registration, to reproduce, manufacture and import or commercially exploit the topography or a product based on the topography.

---

[59] See *Gideon et Gideochem Inc.* v. *Tri-Tex Co. Inc.* (1999) RJQ 2324 (C.A.); (1999) REJB 1426 9C.A.). In this case, the court cancelled a writ of seizure before judgment by which the plaintiff was claiming, as owner, trade secrets that it assimilated to moveable property. The Court of Appeal confirmed that a trade secret is not moveable property as defined at article 734(1) of the Quebec *Code of Civil Procedure*.

[60] *Supra*, note 4.

[61] Supra. note 5.

The term of protection is ten years from the date of application for registration of the topography.

The *Plant Breeders' Rights Act*[62] provides a system of protection for new varieties of plants. Under the Act, the registered holder of plants breeders' rights on a particular variety of plant has the exclusive right to sell seeds of such plant variety as well as an exclusive right to produce seeds of the variety for the purpose of selling. The Act also typically protects a clone, hybrid or genetic variation of a plant. The term of the monopoly right is 18 years with a requirement for the holder to pay yearly maintenance fees if he desires to maintain the protection.

3.5.1 Assignment of Industrial Designs, Integrated Circuit Topographies and Plant Breeders Rights

Section 13 of the *Industrial Design Act* expressly provides for the licensing or assignment of a registered or unregistered design (e.g. at the application stage), either as to the whole interest or any undivided part. The licensing or assignment must be made in writing and must be recorded in the office of the Commissioner of Patents.

Pursuant to section 7 of the *Integrated Circuit Topography Act* any interest in the exclusive rights to a topography, whether registered or not, may be transferred or be the subject of a licence agreement.

Subsection 5(1) of the *Plant Breeders' Rights Act* describes the nature of the plant breeder's rights. Paragraph 5(1)(d) of such Act provides that one of these rights includes the exclusive right to authorize, conditionally or unconditionally, the doing of any act described in the other paragraphs. Section 31 of the *Plant Breeders' Rights Act* prescribes the manner in which the rights may be assigned. An assignee's rights may not be opposable to a subsequent assignee if the assignment was not done in accordance with subsection 31(1) of the Plant Breeders' Rights Act[63].

---

[62] *Supra*, note 6.

[63] Article 31(1) of the *Plant Breeders' Rights Act* provides that the Commissioner shall be, in the prescribed manner and within the prescribed period after the holder of plant breeder's rights has assigned them, (*a*) informed of the name and address of the assignee; and (*b*) furnished with such proof of service of a notice of the assignment on any person granted any of those rights by licence under section 32 as is prescribed or as the Commissioner, in the absence or in lieu of anything so prescribed or in addition thereto, requires.

3.6 Other State Granted Licences

In some cases, particular laws may come into play depending on the area of activity of an enterprise. This would be the case, for example in the area of (i) broadcasting where the Canadian Radio and Telecommunications Commission (CRTC), by virtue of the *Broadcasting Act*[64] has the power to review all changes of control of an enterprise engaged in broadcasting, or (ii) pharmaceutical preparation, where the Therapeutic Product Program[65] (TPP), a division of Health Canada, has the duty, under the *Food and Drug Act*[66] to approve the sale of pharmaceutical products. In such cases, further procedures may be required to ensure adequate transfers of the right to commercialize the various rights acquired.

3.7 Assets in Personnel

Assets in the form of personnel are not strictly speaking a type of intellectual property forming part of the property of an enterprise but rather the advantage that an enterprise has through employing a particular individual. In many cases the impact of the human factor cannot be underestimated, and a successful acquisition of intellectual property may often depend greatly on an appropriate management of human factors.

3.7.1 Impact of Employee/Employer Relationships

In the context of a merger or acquisition a number of employees are often dismissed. When a rupture occurs in the employee/employer relationship an upset ex-employee may take with him client-lists, business plans and other intellectual property. An assessment must be made of the rights of both the employee and the employer.

The jurisprudence in Canada makes a distinction between three categories of knowledge that an employee may acquire during the course of his work:

1. *Knowledge of such a nature that a reasonable person would not consider as confidential.*

---

[64] *Broadcasting Act*, (1991, c.11) http://laws.justice.gc.ca/en/B-9.01/index.html
[65] *See* http://www.hc-sc.gc.ca/hpb-dgps/therapeut/
[66] Food and Drug Act, (R.S. 1985, c. F-27), http://laws.justice.gc.ca/en/F-27/54218.html

An employee may make any use he wishes of this knowledge.

2. *Knowledge that an employee must treat as confidential, either because the employer has indicated that it is confidential or that is confidential by its nature.*

This knowledge, when acquired by an employee, forms part of the intellectual baggage that he will carry with him from job to job. This is referred to as *subjective knowledge*, i.e. the personal and subjective experience of the employee that will remain with him when he leaves his employ.

As long as a contract of employment binds the employee and employer, the employee must retain this knowledge in a confidential manner. This is by virtue of an implicit clause of loyalty that prohibits an employee from revealing to a competitor something that might procure him a material gain.

Upon the rupture of the employment lien between employee and employer, the employee is free, in the absence of an agreement to the contrary, to place at the service of a new employer, even a main competitor, the general knowledge that the employee has acquired with regard to the organization and the business methods of his ex-employer.

Quebec has a particular regime in this regard, which is stated in article 2088 of the *Civil Code of Quebec*:

> *The employee is bound not only to carry on his work with prudence and diligence, but also to act faithfully and honestly and not to use any confidential information he may obtain in carrying on or in the course of his work.*
> *These obligations continue for a <u>reasonable time after cessation</u> of the contract, and permanently where the information concerns the reputation and private life of another person.* (Our underlining.)

It must be remembered that subjective information acquired during the course of his work is not considered confidential information. Furthermore what is considered a "reasonable time after cessation" is left to the appreciation of the courts, which have been reluctant to find that such a time period exceeds 24 months.

3. *Knowledge related to manufacturing secrets, such as formulas or a secret manufacturing process only known by the employer and revealed to the employee.*

   This knowledge is not acquired by the employee during the course of his employment, but rather is knowledge belonging to the employer which is revealed to the employee solely for the purpose of allowing him to manufacture what the secret reveals. This is *objective knowledge*, which remains the property of the employer even after the employee's dismissal.

   It should also be noted that in Quebec, pursuant to article 2095 of the *Civil Code of Quebec*, when an employer dismisses an employee without serious reason, any non-competition clause which may have been entered into, is of no effect. An employer is always well advised to have the employee enter into a dismissal agreement whereby he again agrees to abide by the terms of a non-competition clause.

   In common law provinces, the decision of the Supreme Court of Canada in *LAC Minerals* v. *International Corona*[67] held that three elements were required to establish a breach of confidence (apart from contract):

   1. the knowledge must "have the necessary quality of confidence about it";
   2. the knowledge must have been divulged in circumstances importing an obligation of confidence; and
   3. there must have been an unauthorised use of the knowledge to the detriment of the party communicating it.

   The "necessary quality of confidence" was detailed by the U.K. Court of Appeal in the decision of *Saltman Engineering* v. *Campbell Engineering*[68]:

   > "The information, to be confidential, must … have the necessary quality of confidence about it, namely, it must not be something which is public property and public knowledge. On the other hand, it is perfectly possible to have a confidential document, be it a formula, a plan, a sketch, or something of that kind, which is the result of work done by the maker upon materials which may be available for the use of anybody; but what makes it confidential is the fact that the maker of the document has used his brain and thus produced

---

[67] (1989), 26 CPR 97 (SCC).
[68] (1948), 65 RPC 203 (CA).

a result which can only be produced by somebody who goes through the same process."

4 Licences, Assignments and Other Agreements relating to Intellectual Property

The following table provides an overview of the actions required on behalf of the parties when assigning or licensing a right in statutory intellectual property.

Table 1: Overview of Statutory Requirements for Assignment or Licence

Statute	Assignment	Licence
Patent Act	In writing[69] Registration required[70]	Registration required for exclusive licence[71]
Plant Breeders' Act	Inform the commissioner[72]	No statutory requirements
Trade-marks Act	No statutory requirements Registration optional	Public notice useful to prove quality control by the owner[73]
Copyright Act	In writing[74] Registration optional	In writing[75] Registration optional
Industrial Design Act	In writing Registration required[76]	In writing Registration required[77]
Integrated Circuit Topologies Act	No statutory requirements	No statutory requirements

4.1 Licences

Before a licence is acquired during a merger or acquisition, the buyer must satisfy himself that the licensor had a legal right to grant a licence on the property in question. To do this, the party carrying out the due diligence must be in a position to appreciate the essential subject-matter of the licence. It

69 See section 49 of the *Patent Act*.
70 See section 50 of the *Patent Act*.
71 See section 50 of the *Patent Act*.
72 See section 31 of the *Plant Breeder's Act*.
73 See section 50 of the *Trade-Marks Act*.
74 See section 13(4) of the *Copyright Act*.
75 See section 13(4) of the *Copyright Act*.
76 See section 13 of the *Industrial Design Act*.
77 See section 13 of the *Industrial Design Act*.

has been suggested that the best way to do this is by going to the source of the technology, for example the programmers who developed a particular licensed software or the patent agent or inventor in the case of a licensed patent.[78] A visit of the premises may be needed to perform a verification of this nature. In some cases, it may reveal that the viability of the seller's business largely depends on the existence of licences with third parties, whether as licensor or licensee.

A careful review of all contracts related to the intellectual property of the seller, including all the licences and royalties that are paid by and to the seller is also unavoidable. This will help to provide the buyer with a clear portrait of the potential contractual obligations and restrictions it would be confronted with once the transaction is completed or to determine whether the intellectual property "balance sheet" of the seller reveals a market position that is as strong as it was initially thought to be.

Particular attention must be paid to questions related to the subject-matter of the licences, their duration, their exclusive or non-exclusive character, assignability, conditions for renewal or resiliation, the events that trigger their application and the damages specified if an infringement occurs.

Licence agreements generally include provisions that restrict assignment rights or that cause the agreement to terminate when a change of control occurs with respect to the identity of the licensee (or the licensor). Even if the company that is the target of the transaction is entitled to use a technology or a trade-mark as a licensee, it does not necessarily imply that this right will be transferred to the buyer. In principle, licences are personal to the licensee, which indicate an *intuitu personnae* relationship. It follows that, unless otherwise provided in the contract, a licensee may be in a position where he cannot assign a licence agreement without the consent of the licensor. Additional restrictions may also be found in secrecy agreements that exist between licensee and licensor.

Finally, there may be situations where the seller needs to retain ownership of one or several elements of its intellectual property portfolio, either permanently or on a temporary basis, for transitional purposes. In such cases, it will be necessary to add a licence agreement as part or the transaction to allow the buyer to acquire the rights it needs in order to perform what it intended to do without preventing the seller from carrying on its business.

---

[78] Robert Michelin, *Establishing ownership in intellectual property: Due Diligence Requirements*, Journal du Barreau, October 1st 1997 at p.21

The Right to Grant Licences

At common law, the concept of a licence has been defined as a negative right whereby the licensor agrees, subject to compensation, not to sue the licensee for infringement or the violation of the licensor's rights. The concept of licensing has not yet found its proper place in Quebec civil law. Many have assimilated a licence to a type of rental.[79] However, many features distinguish a licence from a lease. For instance, it is very difficult to reconcile the definition of a lease in the *Civil Code of Quebec* as a contract by which a person undertakes to provide another person with the enjoyment of a movable or immovable property for a certain time, in exchange for a rent[80], with the idea that non-exclusive licences can be granted to several person at the same time, in exchange for royalties.[81]
Article 1016 of the *Civil Code of Quebec* permits an undivided co-owner to use the property. This provision appears to hinder the granting of a licence without the approval of the co-patentees as such a licence on an undivided co-owned property could be seen as infringing on the rights of the other undivided co-owners; there is also a risk of diluting the rights of the other co-patentees. It appears, therefore, that the consent of all the co-owners is essential for the grant of all licences on property held in undivided co-ownership. In fact, in Canada, including in Quebec, the Courts have established that a patentee cannot grant a licence without the consent of his co-patentees[82]. What does not appear to be as clear is whether the co-patentees have to render an account of the profits realized from the licence. The Quebec Court of Appeal seems to impose an obligation to share the profits[83] as it also appears from section 1018 of the Civil Code of Quebec, while, for common law jurisdictions, the Appeal Court of British Columbia does not offer as clear a response on this matter[84].

When a licence is granted, it would normally be granted on the undivided co-owned property as a whole, and not on a portion of the patent held by the undivided co-owner. Article 1025 of the *Civil Code of Quebec* clearly stipulates that the undivided co-owners administer the property in common in its entirety. Consequently, certain decisions as to the undivided property are

---

[79] See *I.G.U. (Ingraph) Inc.* v. *L.B.G.P. Consultants Inc.* (1990), J.E. 90-1224 (Q.C.S.); Stéphane Gilker, "Le *locus standi* du titulaire d'une licence de droit d'auteur: Une question d'intérêt", (1989), 1 *C.P.I.* 1.
[80] See article 1851 of the *Civil Code of Quebec*.
[81] This topic, not being the objective of the present text, it will not be discussed in more detail.
[82] *Supra*, note 31 et 32.
[83] *Supra*, note 31.
[84] *Supra*, note 32.

made by a majority of co-owners, in number and in shares, while other decisions must be made unanimously by all undivided co-owners.[85]

The grant of a licence would appear to require the approval of a majority of undivided co-owners in number and in share since it does not seem to fall under the category of actions requiring unanimous approval.

4.2 Assignments in an International Context

When a merger or acquisition involves the acquisition of technology across national borders, additional efforts must be made to ensure a level playing field, i.e. that all parties to the agreement abide by the same set of rules. In such situations, it is important that control over the technology be determined to ensure that the parties are not entitled, for example, to proceed against each other with respect to any dispute in different jurisdictions.

5 Security Interests in Intellectual Property

5.2 Legislative context

As mentioned in the introduction, for a growing number of businesses, IP represents a substantial portion of their value. Accordingly, lenders have increasingly turned to intellectual property as security for their loans. In Canada, contracts and the transfer of personal property are generally matters falling under individual provincial jurisdictions. However, with some IP assets, it is also possible to register a security interest under a federal regime.

It appears that patents and patent applications, copyrighted works, registered and unregistered trade-marks, registered and unregistered industrial designs, registered integrated circuits topographies, registered plant varieties and, in certain jurisdictions maybe even trade secrets can be given as collateral.

Every Canadian province, except Quebec, has adopted, with some variations, Personal Property Security legislation (“PPS legislation”) that is modelled upon Article 9 of the American Uniform Commercial Code. Security interests in Quebec, on the other hand, are governed by the Quebec civil code, which has merged all previously existing security interests into the “hypothec”, a legal concept of security that is similar to PPS legislation as it concerns moveable property whether tangible or intangible. “Security

[85] Article 1026 C.C.Q.

interest" is defined under the PPS legislation as meaning "an interest in personal property that secures payment or performance of an obligation…". In Quebec, one can hypothecate immovable as well as moveable property, and moveable property includes, amongst others, in corporeal assets. It is thus now clearly established in Canada that most intellectual property rights do fall within the meaning of personal property and, in consequence, transactions involving intellectual property rights given as collateral will be subject to PPS legislation or the Quebec civil code provisions dealing with security interests.

5.2 Validity and perfection of security interests

There are different legislative provisions governing the attachment and perfection of such security interests in the various provincial jurisdictions, but usually a security interest will be created when the debtor signs a security agreement which gives a value to the security and which sufficiently describes the collateral so that it may be identified. Once created (or once it "attaches" to the property), including on floating charges, to enjoy priority over other subsequent claims, a security interest needs to be "perfected" through the proper form of registration (usually a "financing statement") filed with the relevant provincial register.

The main question then is where to perfect a security interest in intellectual property? In this regard, the Quebec civil code and other provincial PPS legislation all contain provisions relating to the forum for perfection of security interests. As an example, section 3105 of the Quebec civil code states that the validity of a security charged on an incorporeal movable is governed by the law of the jurisdiction where the grantor was domiciled at the time of creation of the security, and its publication and effect are governed by the law of the jurisdiction in which the grantor is currently domiciled. With respect to the Ontario PPSA, it states that the validity, perfection and effect of perfection or non-perfection of a security interest in an intangible shall be governed by the law of the jurisdiction where the debtor is located at the time the security interest affects the intangible property in question[86], and that a debtor shall be deemed to be located at the debtor's place of business, if one exists, at the debtor's chief executive office if there is more than one place of business, and otherwise at the debtor's principal place of residence[87].

---

[86] Ontario Personal Property Security Act, R.S.O. 1990, P-10, section 7(1).
[87] Ontario Personal Property Security Act, R.S.O. 1990, P-10, section 7(4).

Accordingly, registration under at least the personal property security legislation in force in the province in which the debtor is located at the time of signing of the security agreement is strongly recommended[88]. Although there are many complex and different rules under provincial legislation for the determination of priorities in the event of a default of the debtor, having a perfected security interest generally means that a creditor will have priority over subsequent creditors who perfect their security interest after him; it also means however that other creditors who perfected their security interest before will enjoy a priority over him. It is therefore necessary to carry out appropriate security interest searches of public registers to determine the rank of the security interests a lender is willing to accept.

5.4 Security interest searches and the IP registers

Although an academic discussion is on-going as to which of the federal or provincial legislation has jurisdiction over security interests affecting IP assets and whether one registration system overrides the other, in a due diligence exercise, all of the appropriate provincial and federal registers should be verified. The federal intellectual property statutes, which create IP rights, provide for their registration and transferability or assignment. They do not however define what is meant by an “assignment” nor do they expressly mention security interests. It appears that the granting of a security interest may in some cases be considered an "assignment" in guarantee. The Copyright Office and the Patent Office (which is also the entity in charge of administering the *Industrial Design Act*) will register security interests or liens against the title of a specific IP asset. As for The Trade-Marks Office, it will place on file a copy of such security interest or lien.

Despite the absence of express registration provisions for security interests, it has become a practice to file such security interests in both the federal and provincial appropriate registers, when such costs are not exorbitant, depending on the number of assets involved (a fee must be paid for each application or registration for which registration of a security interest is sought at the Federal level). It is important to note that the effects of a federal registration without the filing of a corresponding provincial registration are unclear, but the following issues might help one understand the possible effects of not filing a registration at the federal level:

- A prior assignment of copyright is void against a subsequent assignee who has given valuable consideration or licensee unless

---

[88] For example, in Quebec, the Register of Personal and Moveable Property (R.P.M.P.) and in Ontario, the Personal Property Security Registeration System (P.P.S.R.)

notice is given or registration is made in accordance with the act (subsection 57(3) *Copyright Act*).

- A prior assignment of a patent is void against a subsequent assignee who has given valuable consideration unless registered in accordance with the act (section 51 *Patent Act*)[89].
- A prior assignment of a plant variety is void against a subsequent assignee who has given valuable consideration, who has no knowledge of the prior assignment and who becomes the registered holder, unless the prior assignee is registered prior to the subsequent assignee (subsection 31(3) *Plant Breeder's Rights Act*).
- The *Trade-Marks Act*, *Industrial Design Act* and *Integrated Circuits Topography Act* do not make reference to priorities, although it is not unusual to see security interests or liens recorded on such registers.

It should be noted that although searches on the IP federal registers are useful, the security interests and liens or hypothecs granted on IP will not always appear on those registers either (i) simply because some of those rights might not be registered, (ii) because a security granted, for example, on "after-acquired property" cannot be registered against title of those assets on the Federal registers, or (iii) due to backlog in the federal intellectual property offices.

It is also very important to note that the federal IP registers will not deny registration of a subsequent assignment to a third party, even though a previous security interest might have been recorded against that asset. Moreover, they will not even give notice to the secured party of a subsequent registration of assignment or grant of security interest. In light of the foregoing, out of an abundance of caution, where the value of the secured assets is substantial, it is still recommended to file the security interest at both the provincial and federal registers until a clear judicial interpretation of those provisions can be obtained.

To avoid these types of problems, a certain practice has developed whereby rather than taking security against IP rights of the debtor, the IP rights in question are assigned to the creditor until full payment of the loan, with a licence back to the debtor so he can continue to use those assets. While this may solve the problems of having to register the security interest at both the federal and provincial registers as well as the need to enforce the security in case of default, the assignments do impose registration by the creditor as new owner of the IP on the appropriate federal register. Moreover, in the

---

[89] See *Les Poinçons de Waterloo* v. *3288731 Canada inc.*, Quebec Court of Appeal, Court file 500-09-006534-986.

event of litigation involving the IP assets, the new owner would have to become a party to the litigation. In particular, this practice is not recommended for trade-marks because of quality control obligations imposed on the owner of the trade-marks by virtue of the *Trade-marks Act* (section 50) and in most cases the creditor is not in a position to do meet such requirement, nor for patents where the patent owner must be made a party to any action (section 55 (1) and (3)) and where upon his refusal to join as co-plaintiff, the licensee, suing for infringement, must make him a defendant[1]. .

5.4 Enforcement

Finally, upon the default of the debtor, the secured party will have the rights and remedies available in the applicable PPS legislation or the Quebec civil code in addition to the remedies provided for in the security agreement. Generally, those rights will include taking possession of the collateral or the sale of such collateral with the proceeds applied in satisfaction of the loan, after a certain notice period in which any interested party can remedy the default.

6 Tax Considerations

Tax considerations applicable in the evaluation of an acquisition can be very complex, especially when related to technology based deals[1]. The Canadian *Income Tax Act*[1] (hereinafter the "ITA") provides a number of incentives in the form of tax deductions and credits for corporations engaged actively in scientific research and development. Furthermore, the *ITA* provides for a number of mechanisms that may reduce the impact of the taxation process during a merger or acquisition.

The following provides a brief overview of issues that may arise given the nature of the Canadian income tax system as it relates to mergers and acquisitions and intellectual property.

6.1 Eligible Capital Expenditures

Of particular importance to intellectual property assets is the concept of an eligible capital expenditure , which is defined at subsection 14(5) *ITA*. Such

---

[90] See *Pitney Bowes Inc.* v. *Yale Security (Canada) Inc.* (1987), 80 N.R. 267 (FCA); *Bloc Vibre Québec Inc.* v. *Entreprises Arsenault & Frères Inc.* (1983) 76 C.P.R. (2d) 269 (F.C.T.D.)

[91] George S. Takach, *High Tech M&A: The Preparation Stage*, Lexpert, April 2000 109.

expenditures can generally be said to be (i) intangible in nature, and (ii) expenditures for which no other provision exists in the *ITA* which allows for depreciation or deduction from a taxpayer's income (which therefore excludes patents). Furthermore, the asset in question must have been acquired for the purpose of gaining or producing income from a business.

Interpretation Bulletin IT-386R, "Eligible Capital Amounts" provides the following examples of the types of transactions that could result in an eligible capital amount.

1. a person sells a franchise or licence for an unlimited period;
2. a sale of goodwill which would include trade marks or trade names;
3. a sale of a process which an individual has developed;
4. a payment made to disclose the process and allow it to be used by the payer.

Under this heading, therefore, a purchaser can deduct overtime 75% of the costs of acquisition with a rate of 7 % on a regressive base as the costs of customer lists or costs related to the acquisition of trade-marks or copyrights. This includes any costs related to the registration of trade-marks or copyrights. Note that trade-mark and copyrights which have been granted for a limited time period fall into class 14 of schedule II to the income tax rules and are therefore depreciable and not deductible for the purposes of section 14 *ITA* (however any depreciation may be deducted pursuant to paragraph 21(1)(cc) *ITA*). A further eligible capital expenditure is the cost of rights or licences issued under government authority, which could include, for example, the acquisition of broadcasting licences issued by the C.R.T.C.

6.2 Depreciation of Intellectual Property Costs and Undepreciated Capital Cost (UCC)

Pursuant to paragraph 20(1)(a) *ITA* a taxpayer may deduct an amount from certain listed capital assets due to depreciation. The manner in which the costs for intellectual property may be depreciated depends on the type of property in question and is governed by Part XI of the *ITA* and Schedule II of the Regulations, which lists the contents of each class. The method for calculating the deduction for depreciation reveals 4 major characteristics:

1. property to be depreciated is gathered into classes[1];
2. the deduction is calculated based on the undepreciated capital cost (UCC) of all property in a class;

---

[92] There appears to be an attempt to classify assets according to their normal expected life.

3. a taxpayer is entitled to deduct in a given year the maximum amount, or a lesser amount if he so chooses;
4. there is an adjustment following sale or deduction for terminal loss to reconcile any amounts deducted for depreciation with the actual loss in value of the property;

Note that royalties and maintenance fees paid under licensing agreements for the use of a patented invention or other types of intellectual property may be deducted from current expenses.

Intangible properties that do qualify as depreciable properties are listed in Class 14 ("patent, franchise, concession or licence for a limited period in respect of property") and Class 44 ("a patent, or a right to use patented information for a limited or unlimited period"). A class 44 asset can be treated as a Class14 asset (if it had a limited life) or as an eligible capital expenditure (if it has an unlimited life), if the taxpayer so elects. Since the Class 44 capital cost allowance rate is 25% (declining-balance), which allows for a relatively fast write-off, it is usually advantageous to treat the asset as a Class 44 asset.[1]

The costs of acquisition of a patent, for example, which can be grouped either under class 14 or class 44, may be depreciated either linearly at a rate of 10% over 10 years or at a rate of 25% using regressive depreciation. Alternatively, an amount may be deducted each year based on the use made of the patented invention.

The costs of acquiring a copyright for a limited time may be depreciated linearly according to class 14. In the event that the term of usage is for an unlimited duration, 75% of the costs of acquisition may be depreciated using a regressive depreciation of 7%.

Similar to copyright, 75% of the costs of acquisition of trade-marks may be depreciated using a regressive depreciation of 7%. In addition, the costs of acquisition of a trade-mark may be depreciated according to its use.

The case is similar for licences of all of the above types of intellectual property excluding software. In the case of software, the licence may be amortized in the first year (i.e. a 100% deduction), except for operating system software, pursuant to class 12. The costs of acquisition of system software may be depreciated using a regressive rate of 30% pursuant to class 10. Note that a supplementary accelerated depreciation applies in Quebec.

---

[93] HOGG, Peter W. and MAGEE, Joanne E. *Principles of Canadian Income Tax Law,* 1995 at p. 248.

Know-how purchased in the form of services may be deducted as a current cost. The purchase of rights to access information may in some cases be depreciated as an eligible capital expense (i.e. 75% of the acquisition costs amortized using a regressive depreciation with a rate of 7%).

Undepreciated Capital Cost (UCC)

As stated above, one of the major concepts used in the *ITA* in dealing with the acquisition and disposal of capital assets is that of undepreciated capital cost (UCC) and a notional UCC account. When the taxpayer acquires an asset of a particular class the UCC of that class is increased by an amount equal to the costs of acquisition. Likewise, when a taxpayer disposes of a depreciated asset of a particular class, the lesser of the proceeds of sale or the capital cost of the asset must be deducted from the UCC account of that class.

In the event that the notional UCC account is negative following the disposal of an asset, the negative amount must be added to the taxpayer's income for the tax year in question. In this way tax deductions granted for capital assets that are eventually sold at a premium are "grabbed back" by Revenue Canada. The taxpayer can avoid having to declare the negative balance as income by purchasing additional assets of the same class, thus raising the UCC of that class. In the event that an amount still remains in the notional UCC account following disposal of all assets of a class, the terminal loss provisions of subsection 20(16) *ITA* take effect. This notional amount is deducted from income as a terminal loss.

Note that any disposition of an asset in excess of its capital cost will result in a capital gain equal to the excess. Capital gains are taxed in accordance with paragraph 39(1)(a) *ITA*.

In addition, special considerations exist with respect to capital cost for assets purchased other than at arm's length. Subparagraph 13(7)(e)(i) *ITA* deems the capital cost of assets acquired in such a transaction to be the same as the capital cost of the assets immediately prior to transfer plus any capital gain realized by the transferor on the assets (but only to the extent that a capital gains exemption was not applied to the capital gain).

6.3 Scientific Research and Development

A large number of corporations are involved in scientific research and development in Canada in large measure because of generous tax incentives offered by both Federal and Provincial governments. The combination of relatively low rates of corporate taxation and the benefits of tax credits on the purchase of some types of equipment are of particular advantage.

Advantages under the Income Tax Act

The Income Tax Act provides broad incentives to encourage scientific research and experimental development in Canada. What Revenue Canada considers scientific research and experimental development is defined in considerable detail by regulation 2900 of the Income Tax Regulations. Subregulation 2900(1) provides an overview definition of scientific research and development as "systematic investigation or search carried out in a field of science or technology by means of experiment or analysis." Subregulation 2900(1) goes on to define scientific research and development more precisely as:

(b) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,

(c) applied research, namely, work undertaken for the advancement of scientific knowledge with a special practical application in view, or

(d) development, namely, use of the results of basic or applied research for the purposes of creating new, or improving existing, materials, devices, products, or processes.

The federal government offers two principle types of benefits for corporations engaged in scientific research and development: Deductions for all expenses related to scientific research and development and tax credits for investments made in scientific research and development.

Deductions – Section 37 ITA

Expenditures of a current and capital nature relating to scientific research and development carried on in Canada may be deducted in calculating the income from a business carried on by the taxpayer for the year in which the expenditure is made, or may be rolled over and deducted in any subsequent year. This includes all expenses but generally excludes expenses related to the acquisition or lease of immovables (except in the case of "special purpose buildings" which are essentially clean rooms with strict requirements as to the number of airborne particles allowed).

Section 37 *ITA* does not permit the deduction of capital expenditures for scientific research and development made outside of Canada. However, section 37(2) *ITA* allows for a deduction for current expenditures incurred outside of Canada in the year the expenditure was made provided the scientific research and development was undertaken by or on behalf of the tax payer and is related to his business.

Investment Tax Credit – Section 127 ITA

The investment tax credit is available for expenses related to scientific research and development carried out in Canada. The credit is either of 20% or 35% and varies as a function of the type of business engaged in, its taxable capital and taxable revenues, as well as those of any affiliates.

6.4 Withholding Tax When Purchasing Intellectual Property Assets

It is possible to structure the purchase of an Intellectual Property asset in one of three ways:

1. a lump sum payment,
2. payments by installments, or
3. royalties.

The tax implications will vary depending on the manner in which the assets are acquired. Furthermore, paragraph 212(1)(d) *ITA* in general levies a withholding tax of 25% on rent, royalty or similar payments made by a resident (although in certain cases a non-resident is deemed a resident for the purposes of the Act, see subsections 212(13), (13.1) & (13.2) *ITA*) to a non-resident for the purposes of:

(i) Obtaining the right to use a trade-mark, patent, secret formula or a number of other types of intellectual property (subparagraph 212(1)(d)(i) *ITA*);

(ii) services of an industrial, commercial or scientific nature performed by a non-resident where the total amount payable as consideration is dependent on the use or the benefit to be derived from those services, production or sales or profits, but not including a payment for services in connection with the sale of property or the negotiation of contract. (subparagraph 212(1)(d)(iii) *ITA*); or

(iii) obtaining a negative covenant not to use or permit others to use any of those items listed above at (i) (subparagraph 212(1)(d)(iv) *ITA*).

However, the above withholding tax does not apply in the case of royalties or similar payments made with respect to a copyright for the production or reproduction of any literary, dramatic, musical or artistic work (subparagraph 212(1)(d)(vi) *ITA*). These withholdings may be reduced generally to 10% by the application of tax treaties**.**

The withholding tax also does not apply in the case of an outright purchase of a patent or the assignment of an existing licence or in the case of a lump sum payment made for the purposes of obtaining an exclusive right to distribute certain products[1]. It is also of note that the above withholding tax does not apply to payments made for the use of intellectual property outside of Canada (see again subparagraph 212(1)(d)(i) *ITA*).

In the case of computer software, however, which is protected under the *Copyright Act* as a literary work, it is Revenue Canada's opinion that where the taxpayer has obtained an end-user licence to use a computer program which includes the right to make copies for his own personal use, such a taxpayer is not making use of a copyright but is rather exercising his rights under the licence agreement, and therefore the exception does not apply.

Also of note is that pursuant to Article XII, paragraph 4 of the Canada-U.S. Tax Treaty services are excluded from the definition of royalties. As the treaty takes precedence, it overrides the subparagraph 212(1)(d)(iii) that expressly includes services. The provisions related to business profits of the Canada-U.S. Tax Treaty therefore apply to services and no withholding tax will be levied against payments made by a resident to a non-resident in their regard.

Non Arm's Length Transfers
In the event that the transfer of an intellectual property asset is not at arm's length, and the consideration received for the asset is less than the fair market value of the assets, then the deeming provision of Paragraph 69(1)(b) *ITA* applies, and the vendor is deemed to have received fair market value for the asset.

6.5 Tax Free Transfers of Property to a Corporation

The Minister of Revenue taxes 50% of all capital gains at the taxpayer's rate which may result in some onerous tax consequences to a vendor during a transaction that includes the acquisition of a capital asset that has appreciated in value since its initial acquisition. If the intellectual property is depreciable property or an eligible capital property, the transfer could trigger

---
[94] *The Queen* v. *Farm Parts Distributing Ltd.*, 80 DTC 6157 (FCA).

a recapture of deductions claimed for depreciation; this does not apply only to capital gains. If the intellectual property is capital property to the transferor, the gain will be a capital gain and half[95] of the gain will be taxed. If the intellectual property is eligible capital property, it could be taxable as income on half[96] of the recaptured amount.If the intellectual property is depreciable property or an eligible capital property, the transfer could trigger a recapture of deductions claimed for depreciation.

Section 85 *ITA* provides a rollover mechanism by which a corporate asset may be transferred on a tax deferred basis to a taxable Canadian corporation. To take advantage of the rollover, the taxable Canadian corporation, as defined in section 89(1) *ITA*, makes an election provided consideration paid for the asset *includes shares in the corporation*. The election is not automatic and must be made in the form and within the time limits prescribed by subsection 85(6) *ITA*.

Pursuant to subsection 85(1) *ITA* any "eligible property" may be subject to a section 85 election. Eligible property is defined in subsection 85(1.1.) *ITA* and, given the inclusion of eligible capital property (amongst a number of others) in the definition, provides for the rollover of goodwill and other intangibles such as intellectual property acquired via an eligible capital expenditure.

In the absence of section 85 *ITA* the transfer of property to a corporation is a taxable transaction. In such a case the proceeds of the disposition are equal to the value of the consideration received for the asset. This may result in a capital gain, a capital loss, recapture of capital cost allowance or even ordinary income if, for example, the assets sold are inventory.

Where the transferor and transferee corporations do not operate at arm's length, paragraph 69(1)(b) *ITA* operates to deem the proceeds of disposition to be no less than the fair market value of the property transferred. This gives rise, in the case of non-depreciable capital property, to a capital gain or loss to the extent of the difference, if any, between the proceeds of disposition and the cost of the property transferred.

Paragraph 85(4)(b) *ITA* provides that in computing the adjusted cost base of all the shares of the transferred corporation owned by him immediately after the disposition, there shall be added the amount of the loss.

---

[95] For taxation year ending after October 17, 2000.

[96] Under proposals of changes made on 21-12-2000, a choice could be made to tax the amount as capital. The choice could me made for taxation years ended after February 27, 2001.

In some cases when the fair market value of an asset exceeds the cost it is not desirable to make an election under subsection 85(1) *ITA*. This is potentially the case where a transferee has capital losses from other transactions where the transfer can be adjusted to take advantage of those capital losses. The adjusted cost base of the asset as held by the transferor would be increased.

6.6 Divisive Reorganizations

The *ITA* does not provide for any direct distribution of assets to shareholders which do not give rise to tax consequences. However, by structuring the transaction in a manner such that the rollover of subsection 85(1) *ITA* may be applied, in situations involving a divisive re-organization the taxation event may be deferred.

The basic form of the transaction is as follows: the assets (typically a division of the selling corporation) are transferred to the purchasing corporation in exchange for preferred shares with a redemption value equal to the fair market value of the assets in an arm's length transaction[1]. The selling corporation makes an election under subsection 85(1) *ITA* such that the cost base of the preferred shares issued to the purchaser is the cost of the assets. The preferred shares are redeemed whereby the vendor corporation receives a tax-free dividend equal to the fair market value of the shares.

Generally redemption of the preferred shares in such a transaction would give rise to a deemed dividend pursuant to subsection 55(2) *ITA*. However, during a divisive re-organization paragraph 55(3)(b) *ITA* acts to stop the application of subsection 55(2) *ITA*. Paragraph 55(3)(b) *ITA* only applies where the selling corporation is wound-up or all shares in the selling corporation held by the purchasing corporation is redeemed. Furthermore, subsection 55(2) does not apply in the case of transfer of assets between related corporations, as this is not a disposition of property to an unrelated party and therefore the test in subparagraph 55(3)(a)(i) *ITA* is not met.

6.7 Doing the Bump during Corporate Reorganizations

Subsection 88(1) *ITA* provides a mechanism that may be used to selectively increase the cost basis of assets of a target corporation during a friendly take-

---

[97] Some restrictions apply. For example, the assets can only be divided between shareholders pro-rata based on shareholdings. Furthermore, 3 types of property are foreseen and each of these must be divided equally pro-rata with shareholdings.

over. This is referred to as bumping the (adjusted) cost base of the assets in question. In a take-over situation the target corporation may be wound up or merged with the bidder while the cost of the target's shares may be transferred to any eligible capital property.

The essential elements of the transaction are as follows: prior to the winding up or merger, the target transfers the assets in question to a subsidiary. During the merger with or winding up of the target, the bidder transfers the cost of the target's shares onto the shares of the subsidiary, increasing the cost basis of these shares. If the shares in the subsidiary are disposed of to a third party at a later date, any potential capital gains which may have arisen from the disposal will have been decreased by an amount equal to the value of the target shares transferred to the subsidiary's shares.

6.8 Liability for Unpaid Tax

Withholding Tax

As stated above, non-residents are subject to tax on certain investment income derived from Canadian sources. Part XIII (sections 212 to 218.1 *ITA*) imposes a flat rate (generally 25%) on gross amounts. In particular, subparagraph 212(1)(d)(i) *ITA* requires the payment of a withholding tax of 25% on payments in regard to certain types of intellectual property made to a non-resident. The question of residency is one of fact and depends upon the specific facts of each case[1].

The Part XIII flat rate tax exhibits three main characteristics: (i) a non resident must be paid or credited, or deemed to be paid or credited, an amount by a person resident in Canada; (ii) the amount must be credited as, on account of or in lieu of payment of, or in satisfaction of, specified types of amounts including but not limited to the payment of interest, dividends, rents or royalties (as set forth in section 212 *ITA*); and (iii) specified percentages of the amounts are payable by the resident person as a withholding tax on behalf of the non-resident.
It should be noted that the Part XIII withholding tax of 25% is often reduced by tax treaty, of which there are a large number in force at any given time, with the reduction often dependent on the type of investment involved.

---

[98] See e.g. *Denis M. Lee* v. *MNR*, (1990) 1 CTC 2082, 90 DTC 1014 (TCC) for a list of factors which are taken into account when determining residency as well as IT-221R2 "Determination of an Individual's Residence Status".

The Canadian resident acts as an agent of the Revenue Canada in collecting tax under Part XIII from the non-resident. Subsection 215(6) *ITA* provides that where a person fails to deduct or withhold an amount as required by Part XIII, he will be liable to pay the whole amount not withheld. The subsection also allows the tax paid on behalf of the non-resident to be recovered from him. Failure to deduct or withhold may also result in a penalty pursuant to subsection 227(8) *ITA* being levied as well as interest pursuant to subsection 227(8.3) *ITA* on the amounts not withheld. In general it can also be said that this is the case notwithstanding that the failure to withhold was due to a *bona fide* error.