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Integrating IP value assessment into
early-stage M&A activity

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Integrating IP value assessment into early-stage M&A activity

It is generally true that in the early stages of corporate merger and acquisition (M&A) activity, consideration of the target's intellectual property, and in particular its patent portfolio, is the exception rather than the rule. Instead, the target's technology, products and markets are usually the primary focus in the early stages of an acquisition. This phenomenon varies to some degree across different industries and among individual companies. For example, in biological/pharmaceutical M&A, the target's patent position is often of interest to the acquirer. However, most of the time IP assessment is reserved for the later stages of M&A activity, particularly the due diligence stage, which is focused much more on IP-related risk than on IP value. The thesis of this chapter is that the emergence of the corporate-level chief IP officer (CIPO) should facilitate the consideration of IP value in the M&A process.

The role, responsibility and results of the CIPO in the formulation and execution of a company's M&A strategy have only recently begun to receive attention. This results partly from recognition of the value-producing opportunities that can be created by optimal treatment of the IP aspects of these transactions. M&A activity is high as many business sectors consolidate or use start-ups as risk engines for innovation and growth, especially in high technology. For knowledge-based companies, intellectual property plays an important, if not critical, role in a successful M&A transaction. Enterprises are increasingly aware that the proper treatment of intellectual property in the M&A arena can produce superior results. As a result, the CIPO is increasingly charged with the responsibility of managing the IP component of M&A transactions in ways not previously envisioned.

Role of CIPO in M&A process

The CIPO is a recently created full-time position in a growing number of large technology companies, and is responsible for a 360-degree perspective and management

of the IP assets and potential IP-related liabilities of the enterprise to maximise shareholder value using both offensive and defensive means. However, in most large enterprises IP management functions are still distributed among a number of individuals. For example, one person may be in charge of IP litigation, another patent prosecution and another licensing. In smaller enterprises it is often a shared job function assumed by an in-house employee who may also perform other functions for the enterprise. In start-up or emerging enterprises, IP management may be assigned to a senior executive (eg, the chief executive officer), a contract employee, consultant or outside counsel. The CIPO position is based on the fundamental premise that the intellectual property must be managed by, and be the responsibility of, a single person in the enterprise to ensure accountability and results. The level of staffing and resources dedicated to this task tracks the size of the enterprise and the perceived importance of intellectual property to the overall business model. Best practices continue to evolve based on:

- the optimal attributes of the CIPO;
- where the CIPO position should be located in the enterprise's organisation chart;
- the role and responsibilities of the CIPO; and
- the level of resources devoted to IP asset and liability management.

However, it is clear that the CIPO must take a larger role in the M&A process to ensure that the IP component of each transaction is optimised.

M&A is a critical activity for an enterprise regardless of its size, age, technology, market and business model. It usually takes one of three forms: merger, acquisition or divestiture. The M&A process is generally characterised as comprising six successive stages:

- growth strategy formulation;

- target selection;
- opening negotiation;
- due diligence;
- final negotiation and deal close; and
- in the case of the acquirer, post-closing integration.

In the past, IP issues were rarely considered until the due diligence stage. The main focus of IP due diligence is the identification of potential IP-related risks (eg, a third-party patent infringement claim, loss of a critical inbound licence) and the allocation of those risks between buyer and seller (eg, via representations, warranties, closing conditions, indemnification). The focus is on IP risk, not IP value. At this stage, the acquisition strategy has been formulated, the acquisition target has been selected and the purchase price has been negotiated; the only objective of the IP due diligence process is to determine whether there is any IP-related risk so great that the transaction should be aborted. Rarely does an IP risk issue identified during due diligence result in the renegotiation of the purchase price, rather than the cancellation of the deal. However, considering intellectual property so late in the M&A process is not ideal, and often produces considerable loss of value or outright failure. Instead, best practice suggests that the IP component should be considered from the very first stage of the M&A process, and should form an integral part of each subsequent stage of the process.

Since the CIPO is the single point of contact for intellectual property in the enterprise, he or she must drive consideration of IP issues at each stage of the M&A process. The CIPO can no longer be excluded from the M&A process until the target, deal structure and price are determined, with his or her only function being to scuttle the transaction because of an intolerable IP risk. Intellectual property should be viewed as a critical tool in the M&A process that can produce significant strategic and tactical advantages and value when structuring the deal. Therefore, the CIPO should be a key force in the M&A function of the enterprise and an essential member of every M&A deal team.

Six stages of an M&A deal

Stage one: growth strategy formulation

Growth strategy formulation involves the board of directors and senior management exploring potential business development opportunities and charting a course for the future growth of the enterprise. This business development focus necessarily involves an ongoing process and requires examination of many opportunities, trends, models and developments to produce a focus on approaches that are consistent with the

overall growth plan. It is inherently opportunistic since in business there are only two states: growth and decline. Within this development process, the CIPO must ask how intellectual property fits into each approach. There are many ways that intellectual property can be a value driver and not just a risk factor, such as creating entry barriers for competitors to protect market share and profitability, and ensuring freedom to operate and minimising infringement risk via cross-licensing. In addition, the landscape of IP rights in the technology space of the growth plan must be ascertained, along with the IP portfolios of the key players in each area. The CIPO must initiate ongoing investigative and analytical efforts to ascertain the key IP factors in each M&A option under consideration. For many enterprises, an IP investment banker may be a critical player at this stage. Although outside consultants are often used, once this IP activity becomes standardised it will be more efficient to bring part or all of this function inside the enterprise. The output of these ongoing efforts is important input into the M&A function.

Stage two: target selection

Target selection occurs after a growth path has been charted. Specific acquisition targets within that path are examined to determine the best candidates to implement the plan. Historically, intellectual property has not played a role in target selection, which in retrospect seems counter-intuitive, since intangible asset value, and intellectual property in particular, forms such an important part of the enterprise value of so many targets. This IP 'blind eye' was prevalent not only in industries where intellectual property, especially patents, played a minor role both offensively and defensively, but also in knowledge-based industries where 90 per cent or more of the company's market cap is attributable to intangible assets. Since today the role of intellectual property in most industries ranges from quite important to critical, best practice dictates that it must be an important factor in target selection, not only because it will highlight synergies that result from combining IP portfolios, but also because it will identify, as early as possible, those deals that will ultimately fail to close because of right to use and infringement exposure issues. The CIPO must assess the IP positives and negatives for each target being considered, and the results of such assessments should be a key factor in the selection of each target by the M&A team.

Stage three: opening negotiation and pricing

The third stage – opening negotiation and pricing – is when the prospective acquirer approaches the target and begins a negotiation dialogue. Considerable preparation and planning must be done prior to opening this dialogue. The

results of the IP assessment of the target must be incorporated into this preparation. More specifically, intellectual property should be incorporated into the pricing models and negotiation scenarios. This represents the most challenging aspect of integrating IP analysis into the early stages of M&A activity. Pricing, which is largely the purview of the investment bankers for the acquirer and target companies and the boards of the two companies, has always been a numbers game involving financial metrics such as earnings, multiples and ratios. In order for intellectual property to be considered in pricing a deal, IP value must be integrated into the pricing calculus, either quantitatively or qualitatively. However, current methodologies for quantitative IP valuation leave much to be desired. The value of the target's intellectual property in an M&A transaction depends on many context-specific variables (eg, the perceived value to the buyer based on its strategic objectives). Intellectual property that could be of great value to one acquirer may be of little or no value to another. The essential point here is that even though IP value may be difficult to quantify, it should still be considered as a factor in the pricing algorithm. Experience shows that, properly used in a negotiation, intellectual property can have a dramatic impact on deal valuation. It can also be used as an effective lever to achieve other business objectives in the negotiation, such as closing a price gap. In addition, the CIPO needs to make sure that available legal mechanisms are used with the target from the start of the negotiation to preserve legal privileges and immunities during and after the discussions. Otherwise, the CIPO could be in the awkward position of having inadvertently waived the attorney-client privilege during the M&A period that is later needed in legal actions once the transaction is completed.

Stage four: due diligence

The due diligence stage is traditionally when intellectual property is first considered in the M&A process. However, under the best practice approach outlined here, by this stage intellectual property has already received considerable attention. The exception is non-public intellectual property (eg, proprietary know-how, unpublished patent applications, which are typically not disclosed until the price has been agreed). Thus, the focus of due diligence under the best practice approach is to confirm and expand the preliminary value and risk assessment from the previous stage. Typically, this involves examination of the target's IP-related files, as well as consultations with the target's IP representatives. This must all be done in a manner to preserve, as far as possible, all legal privileges and immunities. For example, it is not universally accepted that sufficient common interest exists

between a target and a potential acquirer to maintain privilege in the target's attorney-client communications disclosed to the acquirer during due diligence, especially if the deal ultimately fails. Other relevant issues must also be considered, including the target's exclusivity position, freedom to operate and stacking royalty. In other words, a complete assessment of the IP portfolio and risk position of the target must be made. This assessment should be factored back into the negotiations to refine price where deviations from the preliminary assumptions occur. This is also where the worst-case scenario may develop – that is, discovery of a previously undisclosed IP risk that could derail the closing. The CIPO must be closely involved in this stage since many of the assessments require considerable time and resources.

Stage five: final negotiation and deal close

Intellectual property plays an important role in contract negotiation and drafting, and there must be close collaboration between the CIPO and other team members. The IP-related terms and conditions of the agreements (eg, representations, warranties and associated exception schedules) must be carefully worked by the CIPO. Often IP issues – particularly the scope of the seller's representations and warranties regarding the infringement of third-party intellectual property – are the last points to be resolved during the final negotiation process. All IP deliverables must be carefully documented and checks made to ensure that everything is in order and completed. Care must be taken to make sure that valuable IP rights are not impaired or lost during and immediately after closing, especially if the IP portfolio is large and there are many pending IP matters. The CIPO needs to manage this process carefully to ensure that proper staffing and handover occur. Interaction with the target's internal and external IP counsel must be handled diplomatically, since such external counsel may need to be engaged during and after the closing. The amount of IP work required during this phase can be considerable, so adequate resources must be allocated to ensure success.

Stage six: post-closing integration

The final stage, post-closing integration, is an area that has recently attracted much attention from business managers. IP integration is an important part of this stage. For example, the acquired patent portfolio must be carefully reviewed to determine which patents provide synergy in strengthening the acquirer's patent position. Considerable value can be obtained by the buyer after closing by the monetisation of non-core IP assets in the form of a spin-off divestiture or exclusive field-of-use licensing, and shrewd buyers will factor this post-closing

monetisation into the purchase price. In some transactions the buyer has recouped most, if not all, of the purchase price through such post-closing monetisation. This possibility should be evaluated at stage two, or as soon as it surfaces. An IP investment banker or other IP asset management expert should be consulted about these monetisation opportunities. Consideration should also be given to enhancing the value of the combined IP portfolio by strategic post-closing acquisitions of third-party intellectual property. Finally, the degree to which the IP management infrastructure of the acquired company should be consolidated with, or maintained separately from, that of the acquirer should be carefully considered.

Comment

Under a best practice approach it can be seen that the CIPO adds significant value at each stage of the M&A

process, and no longer merely performs a veto function towards the end of the process. The expenditure of resources for the IP effort also increases through each phase in line with the perceived value of the M&A opportunity, and thus can be modulated based on feedback from the actual negotiations and assessments. The involvement of the CIPO from the beginning of the process provides the additional benefit that if the transaction is completed, the ability to integrate the intellectual property of the acquired entity or to document the transfer of the sold entity's intellectual property appropriately (eg, by recording patent assignments in national patent offices around the world) is increased. In essence, the involvement of the CIPO in a company's M&A deals from beginning to end – and beyond – reflects the integral role that intellectual property can play in increasing shareholder value through the M&A process.

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