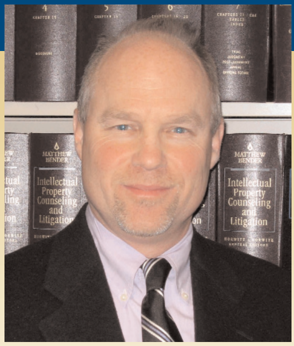

John W. Boger, Esq.
Heslin Rothenberg
Farley & Mesiti P.C.

The Why, When and What of IP Due Diligence Investigations

Whether you are buying a company with cutting edge products, investing in exciting technology or licensing a single patent, the most important thing you need to do before you sign the check (the "when") is to diligently investigate the seller's products or the target intellectual property (IP) and ensure that the amount of the check actually equals the value (the "why"). The depth and breadth of an IP due diligence investigation will vary greatly depending on the type of business deal being contemplated (the "what"), the estimated value of the transaction, the budget allocated to perform the investigation, and the amount of time remaining before the proposed deal's closing date. It is important to remember that not every deal or transaction is the same and, thus, not every due diligence investigation will be the same. For example, it may be important to review patents only in the U.S. and Europe for one type of deal, but for another type of deal patents and trademarks worldwide must be searched. Before any work is started, the intellectual property professional must review with the buyer or licensee all of the transaction factors to ensure that a properly defined scope of investigation will be performed in the required time frame and at the agreed upon price.

Why?

The "why" do you conduct an IP due diligence investigation is simply to make sure that you, the buyer, are getting what you paid for. One of the chief goals for a due diligence investigation is to obtain an unbiased evaluation of the true value of the target company's ("target's") assets. It is commonplace for the buyer to have internal disagreements, (e.g., marketing vs. engineering) over what exactly is the most valuable asset in a transaction. As one would suspect, value comes in all shapes and sizes and really depends on the particular buyer's perspective of future use of the target's assets. For some buyers, true value may be in obtaining the limited monopoly provided by a key patent or license agreement. Another form of value may come from the royalty stream received on technology that has been licensed to a third party. Further, a buyer may see value in a post-purchase change or establishment of a market position within a certain technology field. For example, Company A operates exclusively in the neurology space, but by purchasing orthopaedic Company B and its products, Company A has now entered into and established a presence in the orthopaedic marketplace that complements Company A's neurology standing. Finally, the most tangible form of value from a transaction is cash. This is usually the case when the buyer seeks to make a quick sale of the target's assets or enter into a royalty generating license arrangement with purchased IP following close of the transaction.

When the target's intellectual property is seen as the focus of the transaction, then the engaged professional will be charged with examining all of the IP that may be part of the deal. Specifically, the target's trademarks, copyrights, trade secrets and patents must be reviewed. Many times the IP due diligence investigation will focus only on the target's patents. Glossing over the balance of the target's portfolio may be a critical mistake when trying to determine the true value of the IP. For example, a buyer's marketing department has determined prior to a deal that the target's trademarks have a high valve, but upon further review it is determined that the registrations for these trademarks were never renewed and that in the interim, a third party has applied and obtained similar trademarks that may significantly impact the future use of target's marks. Essentially, the target's failure to keep the trademarks registered has significantly diminished the deal value.

Another reason for performing a due diligence investigation is that such a review will provide the buyer with insight via the IP as to the inherent value of the target's Research & Development (R&D) activities. It is common practice during the course of reviewing a target's key patents for the investigator to be able to assess the technology inventory for current as well as future products that are flowing through the R&D

pipeline. The due diligence investigation will likely reveal to the buyer how the R&D process functions and what the technology protection strategy plan has been in the past. Having this type information will likely be helpful when establishing a true value for the R&D portion of the transaction.

Due diligence investigations are also useful in identifying and exposing over-valued IP assets. For example, the target may have represented that a certain trademark had tremendous value because of its use in conjunction with the wanted popular product, but on further review, it is determined that use of the trademark may be inhibited because of the target's failure to renew the trademark. Therefore, the value of the trademark is significantly less than originally presented. Another example may be that the target has valued certain propriety software at a high value, although upon further review it is determined that no patent application was ever filed, nor was the software registered with the United States Copyright Office. These failures to protect the software may dramatically impact the true value of this IP asset.

Risk assessment and management is another reason "why" one should perform an IP due diligence investigation. Many potential transaction risks pertaining to the IP portfolio will be reviewed, including whether the patents cover the products or ideas that they are supposed to protect, whether the patents are valid and enforceable, and whether the target company actually owns the IP in its portfolio.

Another risk that needs to be identified and assessed is that of any ongoing or possible future litigation. Litigation involving IP may span several areas including infringement or invalidity actions, antitrust and employment disagreements. Unknowingly inheriting an IP litigation matter can be a costly mistake. Documents needed to be reviewed carefully to flush out any clues that a third party, such as a competitor or patent troll, is contemplating an infringement lawsuit against the sellers. The due diligence investigation should also review any pending antitrust litigation due to the possible impact it may have on the target's key patents. Further, any employment litigation involving inventors of key patents should be reviewed because of possible impact on the ownership or validity of these patents. Lastly, any pending administrative actions will need to be investigated such as re-examinations, reissues, oppositions or cancellation proceedings as the outcome of such government actions may have a negative impact on the value of any at issue patents or trademarks.

Obviously, the dangers of not performing an IP due diligence investigation will closely correspond to the reasons why you are engaging in such a review. For example, buying a lawsuit regarding one of the key patents could possibly negate the whole purpose of the transaction. However, other dangers of not performing a due diligence investigation may include failing to identify and mitigating unwanted obligations. Such obligations could be in the form of the requirement to pay unknown royalties or having to grant a patent back because of the transaction. Another unwanted obligation may be the duty to disclose to the United States Patent and Trademark Office newly discovered related prior art that the target had in its possession that may negatively impact the prosecution on one of the buyer's key pending patent applications.

When?

When is the time ripe to commence an IP due diligence investigation? As has been discussed previously, such an undertaking is usually commissioned when one party is entering into a purchase or investment transaction with a second party. The deal may be the acquisition of a business through a stock purchase or asset-only purchase arrangement. Another type of transaction that would compel one or both partners to engage in a due diligence investigation would be a merger arrangement. Yet another type of business transaction that would likely require such a due diligence review would be in a start-up investment arrangement by a venture capital firm or angel investor. Similarly, an equity capital firm would likely engage in a comprehensive IP due diligence investigation before taking a company private or obtaining an equity stake.

IP due diligence investigations, though, are more commonly performed when two entities are entering into some sort of business agreement. These may take the form of a license for certain IP, an assignment of IP ownership rights, a product distribution agreement, a product purchase and sales agreement, an IP joint venture agreement or a collaborative research agreement. Should one forgo an IP due diligence investigation prior to entering such agreements, then certain contract clauses may need to be included to mitigate associated risks. Such provisions may include seller representations and warranties as to the IP ownership, and validity and non-infringement by the IP. Contract provisions that narrow the field of use and provide for exclusive rights should also be considered. Not performing any type of IP due diligence review and just relying on contractually-based remedies is ill advised and may prove to be costly in the long run. The belt and suspender approach of performing a due diligence review and including contract-safeguards before entering into these types of agreements is the most prudent way to lessen the buyer's downside risk.

What?

What is done during an IP due diligence investigation will ultimately depend on the buyer's goal for the transaction. Typically, three basic categories of reviews are performed,

IP Due Diligence Investigations... continued from page 11

including a freedom-to-operate examination, a patent scope, validity and enforceability assessment, and an ownership clearance.

If the buyer's primary goal is to purchase or be able to sell the target company's products, then likely the due diligence investigation will focus on a freedom-to-operate or clearance review. The business objective of such a review is to investigate whether any third party's patents may impact the buyer's ability to make, use or sell the target's products. Before the freedom-to-operate investigation is commenced, it is very important that the current products and future products that are presently in the R & D pipelines are clearly identified.

The first step in the freedom-to-operate review is to conduct a comprehensive search for all relevant patents and published applications. To perform an adequate search on the product portfolio, the target's technology and products must be well understood. In addition, the geographic scope of the review needs to be defined. Lastly, the competitive landscape needs to be investigated so as to identify who is currently operating in the market space and what IP they have.

After the freedom-to-operate search is complete, the next step will be to review and identify relevant third party patents and applications. A review and determination of the scope of the identified patent's independent claims is then undertaken. Finally, the construed independent claims are compared to the target's current and future products to determine whether the target's products "read on" any of the claims or are "free-to-operate" without infringing any third party patents.

Following the review of the identified relevant patents, if any "show stopper" or problem patents are found, several steps must be taken including seeing who owns the patent and determining whether they are a competitor of the target company or a non-player in the target's product space. Additional items to look at are past enforcement history of the "problem" patent by the owner, any design-around possibilities, determining the validity of the claims in the "problem" patent and whether a license may be taken. The buyer should also determine whether the target company knew of the "show stopper" patent and if so, do they have any leverage against the patent or the owner.

If the contemplated transaction focuses on the target company's IP, which may include issued patents and pending patent application or for which it holds a license, a different type of search and review is typically employed. The business objective for performing this different search is to evaluate the overall strength of the target company's key patents. This is accomplished by searching the prior art to determine the scope of the claims being asserted in the key patents and applications. Further, claims in the key patents will also be scrutinized to determine whether they are truly valid and enforceable.

The procedure for a scope/validity/enforcement search will first involve determining the depth of the review needed, taking into consideration the agreed upon budget as these types of searches can be very expensive. The next step is to conclusively identify the target company's key patents to determine whether they cover the target's products, or if they have been written to block out competition. After these preliminary steps are completed, key patents are then prioritized for searching and review.

The purpose when evaluating the scope or claim coverage for key patents is to determine exactly what is protected by the claim and confirm the buyer's expectation of the extent of protection. Evaluating the validity of the key patent claims will usually involve performing additional searches of patents and technical literature to determine whether, during the prosecution of the target patent application, all relevant prior art was reviewed by the Patent Office and therefore, the claims will likely be held to be valid, if challenged at a later date. The last review of the key patents will focus on determining whether these patents are enforceable. The behavior of the target company during the prosecution of the key patents will be reviewed to see if at any time the target acted with an "intent to deceive," meaning certain information (i.e., relevant prior art) was not disclosed to the Patent Office that should have been during the prosecution of the application. If such behavior is found, then the entire patent (or patents) may be found to be unenforceable as a result.

Finally, the last type of search that is usually undertaken during a due diligence investigation is done to confirm whether the seller actually owns or has the authority to transfer title to the IP. The business objective for the ownership/transferability review is to determine whether there is a clear chain of title to all of the relevant IP. The investigation will concentrate on determining whether the inventors or the target company actually own the IP and if proper assignments have been executed. In order to hold clear title, *all* inventors will have had to have assigned the key patent to the target company. Special attention needs to occur when joint inventors are found on a patent to ensure that all inventors have made an assignment to the target company. Also, if any of the inventors are foreign based or the patents are not issued in the U.S., special care must be taken as ownership overseas is determined differently than in the U.S. Further, all inventor employment agreements need review to determine assignment obligations and employment status. Both of these elements play an important role in ownership determinations. Finally, any inventor or target company obligations to third parties through a pre-existing license, research agreement, M&A agreement or joint venture agreement will need review. Due diligence investigators must be wary of hidden co-owners or coinventors. These situations usually arise from university and joint research agreements.

Deliverables

The format of the final report of a due diligence investigation will depend on what the client requires. Written reports may be generated, although many buyers only want to receive the results orally. The pro for having a written report is that the investigation is fully documented. The negatives for having a written report are that comments contained within the report may impair future enforcement efforts of the IP, and the report may have to be turned over during the discovery phase in future litigation. An oral report is flexible, and full disclosure can occur. However, there is no written record for future reference and memories fade with time. The actual contents of the final report will again depend upon the needs of the buyer at the time of deal closure and the focus point of the transaction. Thus, the buyer should dictate to the due diligence investigator what format they would like to see as a final delivered report.

Conclusion

To eliminate or at least mitigate post-purchase surprises and ensure that the buyer gets what was paid for, it is prudent and a best practice to engage a qualified professional to perform a thorough due diligence investigation of the target IP or the products for which they are buying or licensing future rights to make, use or sell.

Please remember that this article and the information provided herein is not intended to be interpreted as legal advice, but is only provided to assist and educate the reader in the various aspects of IP due diligence investigations.

John W. Boger is an associate with the Albany, New York law firm of Heslin Rothenberg Farley & Mesiti P.C. and is a member of the firm's Medical Products and Technology Practice Group. Before attending law school, Mr. Boger worked for eight years with a large orthopaedic device manufacturer in various engineering and marking positions, including as Product Development Engineer. He can be reached at 518-452-5600 or jwb@hrfmlaw.com.

Heslin Rothenberg Farley & Mesiti P.C.
5 Columbia Circle
Albany, NY 12203 USA
518-452-5600 (phone)
www.hrfmlaw.com