Powers of attraction

Whether a company is seeking acquisition targets or potential suitors, it is increasingly the strength of the intellectual property on offer that is the driving attraction. However, the messages to participants are 'buyer beware' and 'seller, be prepared'

By **Haydn Evans**

As awareness of the importance of intellectual property in determining business direction and success grows, companies of all sizes and across a broad range of sectors are recognising the need for a more strategic approach to developing their IP portfolios. This is being accompanied by a rise in IP-related M&A activity.

For major technology corporations, the aims are to protect and strengthen their market competitiveness, ensure freedom to operate and attempt to head off accusations of infringement and costly and time-consuming litigation. For start-up companies, it is often more a question of enhancing the value of their business in the eyes of potential investors/acquirers.

Yet in many deals, the IP due diligence is not diligent enough, leaving companies without a clear idea of the status and value of the intellectual property they are acquiring and the subsequent long-term risks involved. At the same time, vendors – especially smaller start-up companies with little previous involvement in intellectual property – may not appreciate the true value of their assets or, conversely, any limitations on the use of those assets or potential obligations to other rights holders.

Valuing intellectual property has been likened to packaging fog. Dealing with what are often nebulous intangible assets can be clouded in uncertainty, even for IP professionals. However, with intellectual property playing an increasingly important part in the valuation of companies, it is critical that those involved in due diligence in M&A transactions are able to find a clear path through the mist.

Incremental innovation

Confusing the issue further is the fact that true blockbuster inventions are few and far between. Many of today's innovations are incremental, in that they build on combinations of, or improvements to, existing technologies – particularly in those industries where product lifecycles are short and the pace of product development is quick.

For innovative start-up companies, this means that their products might rely on access to third-party technology that, in some cases, may be as much as 15 years old – significantly older than the start-up itself, yet still recent enough to be protected by patents. However, many start-ups are so caught up in the excitement of what they are creating that they give little thought to IP rights. When they do, it is more likely to be in terms of filing patents for their own innovations rather than worrying about whose technology they are building on and potentially infringing to achieve their ends.

More IP-savvy start-ups may have a strategy that sees them generate intellectual property through both their own innovation and the targeted acquisition of third-party IP rights, as we have seen in recent years from Nest Labs, a home automation company headquartered in Palo Alto, California, that designs and manufactures sensor-driven, WiFi-enabled, self-learning, programmable thermostats and smoke detectors. Founded in 2010, Nest continued

Source: Nest Labs

Nest Labs products in the home: the Protect smoke and carbon monoxide alarm (left, ceiling) and the Learning Thermostat (right, wall)

to develop its own innovations, while also acquiring selected third-party patents to protect itself against infringement claims and ensure freedom to operate. It is a strategy that has proved successful as the company has recently been bought by Google for $3.2 billion (see "Building a $3.2 billion 'Nest' egg").

However, the fact remains that while earlier third-party patents are still in force for the original technology on which the latest innovations are based, these can potentially be used to extract payments from start-ups for access to the protected technology or to exclude the companies completely.

In their early years, start-ups usually show little or no profit, making it rare for a third party to be interested in suing them or restricting their activities – there is little point in taking a start-up to court if it is unlikely to have any money. Instead, it can be far more productive and rewarding for a third party to play a waiting game to see whether the start-up flourishes and then pounce.

Attracting attention

For start-ups, growth and success also comes with greater scrutiny, some of which may have unwelcome results – including the threat of patent litigation. This threat is all the more real given that, in the past few years, the number of patent litigations filed has hit record numbers and the majority of that activity is now instigated by non-practising entities.

On a more positive note, successful start-ups will also attract the attention of investors and potential acquirers. In some industries, this can occur even before the start-up has turned a profit – with significant premiums being paid for the potential of a start-up and the technology it has developed.

For the most part, the value that an acquirer sees is tied up in the target's intellectual property, especially in the form of employee know-how. If applications of this are restricted by third-party IP rights, much of the target's value can be at risk. Equally, if internal intellectual property has not been properly protected by patents and other IP rights as appropriate – or if those rights are not properly maintained – there may be nothing to prevent copycats taking market share and eroding the company's value.

With this in mind, prospective M&A targets are increasingly recognising that they need a well-thought-out IP strategy to appeal to potential investors. In industries where successful product development relies

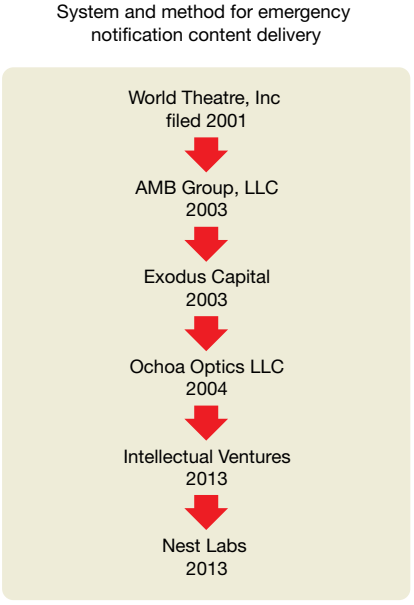
Building a $3.2 billion 'Nest' egg

When Google announced in January this year that it was to buy Nest Labs, a home automation company headquartered in Palo Alto, California, for $3.2 billion, it underlined how start-up companies can build significant value in their business through innovation and a shrewd IP strategy.

Nest designs and manufactures sensor-driven, WiFi-enabled, self-learning, programmable thermostats and smoke detectors. It was founded in 2010 by former Apple engineers and has been very successful in a short space of time. A strapline on its website reads: "We're Nest. We reinvent things." This apparent acknowledgement of being innovators rather than originators perhaps helps to explain why, for a start-up, it was so keen to develop an IP strategy and significant patent portfolio. Its general counsel, Richard Lutton Jr, was quoted in 2013 as saying: "To date, we've filed almost 200 US and international patent applications and we have hand picked and acquired more in key areas. Our patents allow us to defend our innovative products in the market."

A quick search on the US Patent and Trademark Office (USPTO) patent full-

Figure 1. **US Patent 7,233,781 transfer history**



text search databases with Nest Labs as the applicant reveals patents and patent applications with priority dates from 2010 onwards, covering everything from thermostat interfaces to climate control algorithms. What is perhaps more interesting are the patents and applications that Nest has hand picked and acquired. The story and the rationale behind how it acquired these patents reveal a lot about the current threat of patent litigation, the patent market in general and the role of patent aggregators or non-practising entities.

The acquisition of these patents may well have been prompted by the ever-present threat of patent litigation. Nest's growing success did not go unnoticed. In February 2012 Honeywell filed a lawsuit claiming that Nest had infringed some of its patents. On May 14 2013 Allure Energy, Inc was issued a patent by the USPTO entitled Auto-Adaptable Energy Measurement Apparatus. The very same day, Allure filed a lawsuit in Texas against Nest and two other defendants alleging that Nest was infringing its newly issued patent. On November 4 2013 BRK Brands, Inc (maker of the First Alert brand of smoke detectors) filed suit against Nest in Illinois, alleging that Nest's newly released Nest Protect product infringed claims from six of its patents.

These litigations are ongoing and the patents that Nest has acquired may be part of its future defence strategy.

A search through the USPTO assignments online database reveals a large number of patents and applications reassigned to Nest from an individual inventor, Lawrence Kates, but also acquired patents that were originally applied for by a number of individual companies: Zome Energy Networks, World Theatre Inc, Xanboo Inc, Silicon Labs Inc, Lockheed Martin, Coraccess Systems LLC and Valparan Development LLC (see figures 1 - 3). Some of these companies still exist, while others – despite their innovation – have not fared so well.

Take for example, World Theatre, which went into liquidation back in 2003. The failure left behind 300 shareholders, 62 creditors in North Carolina, $12 million in debt and some 30 patents pending. In fact the patents, now granted, that Nest acquired were filed in the early 2000s – and were clearly thought to have significant value. Before World Theatre went into liquidation, the judge allowed Exodus Capital – a major creditor based in Atlanta – to assume a role in keeping the patent applications live. World Theatre owed Exodus nearly $7.2 million from notes issued in 2002 and 2003.

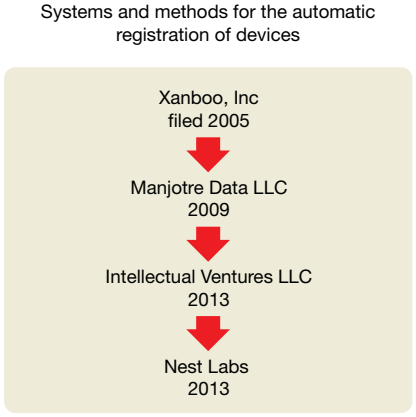
In November 2004 some of the patents were sold from Exodus to a company called Ochoa Optics – an organisation apparently named after the world's first Hispanic female astronaut, Ellen Ochoa – which appears to be a holding company of patent acquisition company Intellectual Ventures (IV). In August 2013 the patents were reassigned from Ochoa Optics to IV and then, later that month, the patents – as well as others from IV – were bought by Nest in a bid to bolster its patent portfolio.

The IV connection continued in September 2013 when Nest announced that it had entered into a patent licence agreement with IV and, additionally, was acquiring several of IV's patents to help Nest better defend its products from patent infringement claims.

If building up its patent portfolio was designed to create value for the company, the acquisition by Google would suggest that Nest got its strategy right.

Figure 2. **US Patent 7,047,092 transfer history**

Figure 3. **US Patent 7,250,854 transfer history**



on bringing together a number of integrated technologies, patents — or access to patents — can be vital in ensuring success and attractiveness for funding or acquisition.

To ensure the best deal, a target must be well prepared. It needs to understand the IP landscape in which it operates, the strength and value of its own intellectual property in relation to the market, and the importance of its intellectual property and protected IP rights to potential acquirers in successfully pursuing their own business objectives. Ongoing patent searching, together with competitor patent alerts, will provide much of this intelligence. Armed with such knowledge, the target will be in a stronger position when it comes to negotiating the deal.

Buyer beware

Historically, IP due diligence from a buyer's perspective in M&A transactions was largely a back-office 'tick-box' exercise based on a rudimentary assessment, often conducted at the eleventh hour. If the IP department was consulted at all, it would likely only be for answers to questions such as: "Do these people own the intellectual property they say they own? Are they going to maintain these IP rights throughout the

Action plan

Given the importance of intellectual property in M&A transactions, a thorough due diligence investigation is vital to ensure the long-term success of a deal and avoid any unpleasant surprises. The key is to start early. IP due diligence has to be top of the agenda as soon as potential target acquisitions are identified.

It is important to gain a comprehensive understanding of the target's IP portfolio and its IP strategy – whether it is designed to boost the company's competitiveness and drive commercial growth or simply to protect what it has.

You will also need to identify and understand the following:

- the IP assets that are critical to the target's ongoing and future commercial success;
- how the acquired portfolio will complement your existing IP portfolio – the gaps it will help to fill and where there may be overlap;
- whether the patents provide you with competitive leverage/competitive advantage;
- the relevance of the target's patents – whether they are just for defending its own products or whether there are patents that others might want to license;
- the strength of the relationship between the target's R&D, IP portfolio and product/service range;
- the age profile and geographical scope of the patents – for how long and where can they be enforced;
- whether the company is still filing patents – if so, what and where;
- whether the patent portfolio relies on only a handful of key inventors; and
- possible encumbrances – are some patents licensed to third parties or currently the subject of litigation?

It is not always easy to value intellectual property, even for IP industry specialists. However, by giving due consideration to the issues outlined above, an acquirer can start to get a feel for the value of the target's IP portfolio and any significant upside that may exist, while also identifying potential risks to future growth.

From a seller's perspective, awareness and preparation are essential. When dealing with would-be suitors, a seller needs to understand the broader IP landscape in which it operates, the strength and value of its own intellectual property in relation to the market, and the importance of its intellectual property and protected IP rights to potential acquirers in successfully pursuing their own business objectives. With this information in hand, the company is likely to find itself in a stronger negotiating position.

For both buyers and sellers, patent landscape searches and competitive IP research can be valuable tools in helping them to appreciate better the value of the IP assets on offer – and to make more informed decisions.

life of the deal? Are any of the IP rights licensed to a third party? And do we need to review these arrangements before we acquire the IP portfolio?"

While these basic questions have not changed in recent years, intellectual property is now more frequently addressed upfront in the deal process — indeed, for some deals, it is the driving force behind the transaction. This trend is exemplified in technology-intensive industries, where the majority of a company's value resides in its intangible assets. However, it is not just the inherent value of the assets that is attractive to potential acquirers; the deal is equally important in terms of how the assets are currently being leveraged and, crucially, whether they can:

- be deployed/exploited to provide competitive advantage;
- secure even greater commercial returns;
- fill technology gaps in an IP portfolio;
- mitigate the risk of being out-manoeuvred by competitors; and
- reduce the threat of IP litigation-related risk.

So a simple numerical count and legal check of the target's intellectual property is not enough. Thorough patent landscape searches and competitive IP research are required in order to understand the business and market context, and better appreciate the value of the IP assets on offer.

Therefore, it is important that those IP rights are investigated thoroughly and fully understood (see "Action plan"). A due diligence investigation into a company's IP assets should cover the following main areas: patents, employee know-how, trademarks, copyright, licences and collaboration agreements. It should also identify actual or potential third-party challenges, which in turn could diminish the value attached to the target's intellectual property.

In this way, IP due diligence plays a crucial role in ensuring that a buyer does not end up empty-handed or overpaying for the target's IP assets. Large transactions usually involve a suite of IP items and, often, investigation reveals that the target has registered some, but not all, of the intellectual property used in relation to its products. In some cases the intellectual property may not have been protected in all of the territories in which the company operates, while in others the company may simply have neglected to maintain its rights.

Properly conducted IP due diligence can also provide the parties with a powerful negotiating tool before the transaction's conclusion. For example, if the investigation shows that the target's intellectual property has not been adequately protected and managed, the scales may be tipped in

favour of the acquirer. On the other hand, the investigation could also benefit the seller where it is shown to have a history of proper and prudent IP management, such as selecting innovations with the highest potential to protect with IP rights, taking steps to ensure early protection and involving all stakeholders – from marketing to R&D – in the process. This will not only facilitate the due diligence investigation, but will also pay off when the company decides to capitalise on its investments.

Look before you leap

In today's fast-moving technological world, the valuation of companies depends to a much larger degree on the knowledge that they own. Therefore, it is hardly surprising that the value and commercial potential of their IP assets are more important than ever in M&A transactions. However, in the rush to acquire more IP rights to boost their own competitive position and valuation, it is important that buyers are not blinded by the attraction of the assets seemingly on display.

The advice to potential buyers is to conduct thorough IP due diligence, examining both the upside and the risk. Meanwhile, for a company seeking to raise capital or cash in on its IP assets, having a clearer sense of their value and their importance to a buyer's business strategy is key to assessing the seller's competitive strength and market advantage – and potentially helping to increase the multiples on its valuation.

In either case, the message both to the wooer and the wooed is to look before you leap. ***iam***

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