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Getting due diligence right

Extensive IP due diligence is a necessity, not an expensive luxury, when considering whether to invest in a company. The trick is to know what you should be looking for

In the area of intellectual property, there are a number of questions that any investor should check before becoming involved in a company. This means looking closely at patents, trademarks, utility models, designs, domains, real names, vanity numbers and secret know-how. In this column, space limitations mean that I will concentrate on patents.

It is helpful to start with two tools:

- A comprehensive overview, which includes data, owners, comments and the current status of all property rights. Don't forget the countries for patent families. Usually, you can get these tools from the management of the company. Counter check the data at least for the most prominent patents, trademarks and other rights.
- A patent-product matrix. Don't forget to check whether the claims of the patents in the patent-product matrix really cover the products. It is not uncommon to find that while in the beginning the claims of the patent applications and the product development in the laboratory were consistent, over the course of the years, the product has been improved and changed and so have the patent claims, but for different reasons. The claims often have to be changed during prosecution due to state of the art cited by the examiner. The development of the product and the changes the claims might well diverge.

Also determine who owns the patents or patent applications. The owner should be the company you are interested in investing in. But is this actually the case?

Sometimes, the founders or the CEO or their wives own the patents. In that case, we have to insist on the patents being assigned to the company as part of the investment contract. This will lead to discussions. As investor, however, you had better be intransigent on this point. It is generally much better to be the owner of a patent than to be just a licensee. As an investor, we buy shares of the company. We, therefore, want the company to be as strong as possible.

Who are the inventors? How did the rights pass from the inventors to the company? Are there any remaining rights held by former employers, eg a university? In such a case, try to get hold of as many rights as possible, in the name of the company you want to invest in. Try to buy the remaining rights. If this is not possible, try to get an exclusive licence. If this is not possible either, well - the deal might break.

It is also important to look at issues surrounding validity. For example, what are the chances of outstanding patent applications being granted? Is there any official novelty search report or any office action? Or any other search report? If yes: what is the result? If no: order one yourself. Or make one yourself. There are very helpful tools on the internet nowadays which ease and speed up this work. I use www.ipcentury.com.

Watch out if you are dealing with professors. They may have published their ideas prior to filing a patent - quite common in academia. Since every professor is proud of the number of publications he has, it will not be difficult to find his list of publications on the internet, presumably with a hyperlink to the full text. Have them explain their publications to you and the difference between the content of the publications and the patent.

Is the matter patentable at all? There are restrictions on software patents as well as for patents in the field of medical technology.

Make sure to determine whether there are any patents owned by third parties that the products of the company might infringe. In an extreme case, the company may not even be able to sell a single product because of this. Until recently, a decent infringement analysis was a prohibitive effort and, thus, was usually disregarded, even though it could be more than important. Luckily, we can now turn to sites such as www.ipcentury.com which offer automated infringement analysis.

For a really thorough due diligence, you should analyse the patent portfolio of the major competitors and, in general, analyse the worldwide patent landscape in the technical area of interest. This, however, cannot be done easily, at least to my knowledge.

Crucial too is to determine exactly what the patent claims cover. What is the scope of protection? Is there an easy way to work around this patent? Does the patent offer an interesting monopoly position? Can infringement of the patent be detected? In short: what is the value of the patent?

Finally, pay close attention to the quality of the specification, the breadth of the claims and the quality of the prosecution work. This will, eventually, have an influence on the value of the patent. Potentially, consider a change of the patent attorneys and/or law firm the company uses.

Level of scrutiny

What is the level of scrutiny to which such an IP due diligence can be driven? As a rule of thumb, the costs for the IP due diligence should normally not exceed 1% of the investment sum. This is, as mentioned, only a rule of thumb and may vary largely depending on the industry sector, the age of the company, the amount invested and so on.

Generally, you should concentrate on the most prominent one, two or three patents for the more extensive levels of scrutiny. You should always be very thorough as far as the ownership is concerned. Validity can be found in the second rank. Infringement, value and quality come next.

With seed and start-up investments, you are usually dealing with patent applications rather than with patents. Here, validity is a big issue. As far as the value is concerned, you might try to judge whether the major patent applications cover a core technology, a development platform or an application level. Clearly, a patent application covering a core technology has a higher value than the others.

When it comes to investments in early-stage companies, you will probably find a mixture of patents and patent applications. In this case, it might be much easier to judge at least the validity of the most important patents. Also, questions of ownership might long ago have been resolved.

Investments in later stage companies might involve portfolio evaluation.

And the key to it all? Don't forget anything important, but please don't spend too much time and money.

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