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Is IP a deal breaker?

There is a common misconception that intellectual property will not make or break a deal in the venture capital world. But the truth is that it can and it does

Every venture capital investment shows two major points of decision. In the beginning, there is the investment. At the end, there is the exit (in one way or another).

During the investment process, a VC is the purchaser. Other people try to sell part of their company to the VC. The investment phase at the beginning involves extensive due diligence. Part of this due diligence is taken up with looking at the intellectual property of the company in question. That company will try to make its IP look as good as possible.

Some years later, the roles are exchanged. During an exit, the VC is the vendor and tries to sell his share of the company to the purchaser. The purchaser will perform an extensive due diligence. Part of that due diligence will – surprise, surprise – involve looking at the IP. The VC will then try to make the IP of his or her portfolio company look as good as possible. (It should have improved since the time of investment!)

What influence does IP due diligence have on the decision to be taken? Will IP be a deal breaker?

Let's focus for the time being on high-tech companies. When looking at the IP of high-tech companies, you may find patents, trademarks, copyrights, software, etc. But as we are talking about technology companies, let's concentrate on the patents.

Trademarks will become more important as the turnover of the company rises and the company becomes publicly known to a larger extent. For young high-tech companies that are exclusively involved in business-to-business transactions, the trademark portfolio might entirely vanish after a trade sale – in the extreme. But it might also survive as the name of the product that is integrated into the acquiring company.

Anyway, let's concentrate for now on patents.

If you ask some professionals about how important the IP is when they look at a company, they would answer that, in their experience, IP in the end is generally not a deal breaker. Often these professionals are involved with software companies. The IP due diligence might come down to no more than taking care that the IP is owned by the company. This makes everybody feel comfortable with the IP portfolio. And that's it.

This is fine if you are selling part of your portfolio company. But if I were purchasing, I would be more careful than that. Nevertheless, this rather relaxed attitude may have something to do with the widespread opinion that software patents are more likely to be circumvented.

My recent personal experience lies more in the realm of medical technology. If core IP is missing or if there is a threat of IP litigation, the deal has broken. Also, if the company is potentially infringing a patent of the major competitor in a duopoly situation, if opinions are missing or if opinions are not convincing, likewise the deal has broken.

So the answer to the question of whether IP is a deal breaker is, in my opinion, the following: IP can always be a deal breaker. Depending on the industry sector you are dealing with, the importance of IP can be differentiated.

No doubt, in the pharma and biotech sectors, there is nothing more important than patents. A drug that is not covered by a patent is worthless. Patents are always deal breakers.

Patents will also most probably be a deal breaker where a company produces a material high-tech product. This might be the case for semiconductor, medical technology, telecommunication and optics companies.

Patents might play less of an important role in the software industry. As stated above, the common belief is that software patents can be more easily circumvented than other patents. Also, in Europe, not every single software invention can be patented. There is an endless discussion about software patents going on in Europe. The ultimate political decision on the level of the European Union has not yet been taken. (For details please contact your patent law firm.)

Anyway, there is a definite deal breaker in every industry sector, and that is where the company to be sold is not in possession of the most important patent, neither has it an exclusive licence (that cannot be terminated by the patent owner). If the patents are still held by the founders, you will be in trouble when it comes to an exit. In that case you might be better off without any patents at all. That will considerably reduce the price, but the deal might still be closed.

Some say that IP questions are more important in trade sales than in IPOs. I will leave this without a comment. This is the year 2004 and not the year 2000. Since trade sales are the predominant exit way, you should be prepared. Who knows what will happen?

As a consequence, every venture capitalist should be careful to build a strong IP portfolio for every single one of his or her portfolio companies, just to be prepared. A strong IP portfolio:

1. demonstrates the innovation potential of the company;
2. is an indicator of sustainable turnover;
3. is an additional asset;
4. reduces the risk of broken deals; and
5. bottom line: considerably increases the exit value.

And please, look at intellectual property from day one. Patents take a few years to be officially examined and granted worldwide.

Be prepared.

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