

The changing face of due diligence

It has always been important to be sure that the IP you are acquiring is the IP you want. However, the growing number of ways in which rights can now be monetised means that due diligence is more vital than ever before

By John Pryor

Over the past 10 years IP has not only entered the conscience of the general public, it has also propelled itself into the boardrooms of most corporations. High-profile cases such as the *RIM v NTP* patent case and the much publicised purchases of myspace.com and youtube.com have meant that IP has hit the headlines.

Alongside these, a stream of celebrities including Brad Pitt and Angelina Jolie, and England and Manchester United footballer Wayne Rooney have been involved in major domain name disputes. The Sarbanes-Oxley (SOX) Act in the US has introduced some complex ramifications for businesses and the way IP is managed.

The entrance of IP auctioning in 2006 has also brought with it a significant change in the perception of IP among business professionals. All of which means there is an increasing need for companies to think about mitigating some of the risks associated with this increased commercialisation of IP.

IP for the masses

Intellectual property is arguably more mainstream now than it has ever been. We come across it in our everyday lives, from counterfeit goods and possible links to major crime, to celebrities protecting their image rights. Rankings of patent and technology strength are now part of the *Wall Street Journal's* weekly financial coverage, where new patent scoring/rating is being translated into financial metrics.

Product marketers are also using patents as a valuable tool in advertising in increasingly competitive markets – one of

car manufacturer Audi's campaigns emphasises that they have more patents filed for one car than NASA has filed in total. In the BBC television programme *Dragon's Den* – a reality series where inventors and entrepreneurs pitch their ideas to successful business people and compete for investment – owning a patent is often seen as a green light to do a deal.

However, in this hit UK series even the shrewd 'dragons' do not investigate the patent before they invest. This is not an uncommon occurrence – most companies still do not understand the complexities of IP. In the words of David Wanetick, managing director and chief IP officer of research think tank IncreMental Advantage: "Most institutional investors and corporate managers respect intellectual property as a legal construct. However, both Wall Street and Corporate America have failed to appreciate the value-generating ability of IP. Thus, corporate America has neglected to actively manage its IP portfolio and professional investors have been remiss in trying to assess the value of IP resident in the companies in which they invest."

And it's easy, even for the IP professional, to get caught up in the media's perspective of IP. Practitioners sometimes have to go right back to basics to ensure that any business strategy fully incorporates the risks and value of the associated IP rights.

It's now widely recognised that the surge of what has been coined the 'knowledge economy' has increased IP's level of influence in business, from R&D, corporate transactions and brand development perspectives. However, many CEOs and CFOs are still unaware that scrutinising an IP portfolio can mitigate a number of risks associated to the

purchasing and in-licensing of rights, and that a relatively small investment can pay dividends in the long term.

For those wishing to sell, out-license or simply get their portfolios in order for SOX compliance or for day-to-day transparency, there are measures that can be undertaken to reduce risk and benchmark the sale value of trademarks, patents and domain names. Ultimately, a well-managed portfolio will make the first steps to exploitation, securitisation or disclosure much easier.

Purchasing IP

Ocean Tomo's 2006 auctions have forced professionals to re-address the way they think about buying and selling IP. The auctions have received a varied reaction, but, whatever you think of them, they are indicative of the increased frequency of patent transactions and investment in already established brands. Eg. BMW buying Mini and Procter & Gamble buying Gillette. In order to avoid a later sting in the tail, it's important for a purchaser to do the groundwork in IP evaluation. So what should companies seek to be aware of before they start transacting?

Purchasing patents

There are several questions to ask before purchasing a patent – some appear simple, but if forgotten could be detrimental to a business. For example:

- Is the patent valid?
- Are the annuities paid and up-to-date in all jurisdictions?
- When does the patent expire?
- Will you have freedom to operate?
- Does the vendor own the IP?

Most IP transactions will include reps and warranties to cover any weaknesses in the portfolio; however, if these are discovered post transaction, the costs to the business can be significantly greater than those associated with some basic pre-transaction checks. For example, barriers to entry can prevent or delay any development post-purchase, so it's important to understand and identify these from the outset.

There have also been several cases where the IP owning entity has changed hands and the relevant IP rights have not been assigned from previous transactions, so that the new owner has been left with a legalistic can of worms in order to claim its rights of ownership.

The vendor should be able to provide answers to all of the questions above if its IP is in order; however, there are currently no

selling standards like those you might find in consumer retail and many portfolios contain some hidden fundamental issues. Demands for clear answers should be placed on vendors as a standard, but the reality is different and purchasers would be wise to request detailed information about the IP prior to purchase.

Whether the purchase is a portfolio of patents or a single patent, at a minimum the acquirer should demand that the patent data they will acquire is valid and up-to-date. A good understanding of the available patent information should equip the purchaser with a clearer picture of whether to move forward with the purchase.

The second level of investigation should relate to the sale price of the patent. There are several methodologies for patent valuation, including cash flow models or the capital market approach, and the more historical transactions available, the easier it will be to do the valuation. Ocean Tomo's general counsel, Raymond Millien, recently said: "The emergence of a significant data set of comparable patent transactions will [also] aid inventors, IP practitioners, companies and governmental agencies in pricing and valuing patents in the future." (*IP Review* magazine, issue 16, autumn 2006).

Whilst there are no universal patent

Sample due diligence checks: patents

Type	Description	Result
In force checks	Legal status and maintenance fee checks.	Helps to assess the status of IP
Freedom to operate search	Identify obstacles and barriers to entry of a product in a patent jurisdiction	Help to understand the rights to be able to make, sell and/or use the company's products or services.
Validity/invalidity search	Determine the novelty of a patent – search focuses on the claims of the patent. Search results can also be used for offensive and defensive purposes.	Helps to assess the scope of protection and strength of coverage of the assets.
Litigation search	Check for infringement lawsuits for patents. Using public databases (eg, Litalert database).	Helps to determine the limitations of rights being assessed.
Competitive and industry intelligence reports	Evaluate the strengths of the acquisition target against industry competitors. For example, assessment of relative strengths versus the top competitors.	Helps to determine the value of patents in the marketplace.
Title verification general title clearance	Check all patent names have been assigned to the target in all countries.	Helps to determine whether the company owns all the rights in all the countries it says it does and whether title is correct.

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Sample due diligence checks: trademarks

Type	Description	Result
In force checks	Legal status and maintenance fee checks.	Helps to assess the status of the IP.
Freedom to operate search	Identify obstacles and barriers to entry of a trademark in a particular class or jurisdiction.	Help to understand the rights to be able to make, sell and/or use the company's products or services.
Litigation search	Check for infringement lawsuits for trademarks. (WIPO)	Helps to determine the limitations of rights being assessed.
Title verification general title clearance	Check all trademarks have been assigned to the target in all countries.	Helps to determine whether the company owns all the rights in all the countries it says it does and whether title is correct.
Brand valuation	Looks at the value and perception of a brand.	Helps to determine and measures how much the brand is know or recognised by its audience.

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valuation techniques, newer approaches such as patent scoring/rating can help to differentiate and benchmark one patent against another or one corporation against another, as well as tracking innovation movement. Additional mechanisms including using patent analytics – sometimes referred to as data mining – for an industry as a whole, or the direct competition in conjunction with patent searching, can also help to gauge how an industry or competitor places value within a patent/patents. Patent citation is particularly useful in this arena and a good analyst will be able to see the knowledge transfer that has led to a strong patent. Citation analysis highlights 'improvement' patents as well as the owners of prior art and in turn also identifies innovation creators and industry followers. This information can be used to further identify the significance of a patent and therefore aid in the assessment of its value.

Once all of the necessary checks have been made, and information is gathered, the ultimate value of the patent lies with the purchaser and how much they are prepared to pay for it.

Purchasing trademarks

Because trademarks are the legal entities that support brands, it can be difficult to separate trademark value against brand value. Companies such as Interbrand can provide brand valuations, based on a specific set of metrics; however, many brand owners have not invested in this kind of valuation, as the process can be relatively time consuming and is often pricey. If you are entering into negotiations or an auction,

it isn't usually feasible to conduct a full brand evaluation, but there are certain checks that can be carried out from a legal and practical perspective that can help to determine the worth of the trademark.

As with patents, perhaps the first questions to ask are: does the vendor own the IP and, if purchasing a portfolio of marks, what IP is included in the transaction? Title and formality work for trademarks is generally more complex than for patents, so checking this should definitely be a priority. A recent example relates to a large European automotive manufacturer which spent £79 million in acquiring a luxury car-maker, only to find that the car's prestigious trademark was not included in the deal and had, in fact, been sold to the purchaser's main rival.

Checking the classes in which the trademark is registered and looking into additional classes that may be of interest is also useful. It will be fascinating to observe the legal wranglings between Cisco and Apple over the classification and rights for the iPhone trademark, following Apple's launch of the iPhone.

Purchasing domain names

Since the dot com boom and bust of the late 1990s, the web has fought back with a vengeance. The IP industry has witnessed the arrival of the domainer – the domain name professional who exploits domain names for financial gain. But what measures can brand owners take to ensure that they are pricing their domain assets accordingly so that domain purchasers aren't being ripped off?

Many of the standard, legal status and data checks are similar to those used for patents and trademarks. However there are certain due diligence elements specific to domain names. For example, for litigation information, the purchaser can access either WIPO (<http://www.wipo.int/amc/en/domains>) or, for more information in the US, the National Arbitration Forum (<http://domains.adrforum.com/>).

Unique to domain names is the ability to monitor traffic to a website. Because this is something that can be looked at in real time, it is a useful component in the valuation kitbag. Assessing the amount of web traffic can be used to distinguish elements of market value. Often, domains with a high percentage of accidental traffic achieve a greater asking price, so if the purchaser is aware of traffic analysis the information can be used to bargain with the vendor or to recognise whether the deal is a good one.

Selling IP

IP due diligence is important from a purchaser's perspective, but it should also be equally as important to a vendor. Anyone intending to sell patents, trademarks and/or domain names will want to be able to ask for the best possible price.

Despite domain name and patent deals at auction reaching over US\$200,000 and US\$900,000 respectively, these are not the norm. and vendors would benefit from carrying out some due diligence prior to putting a price on their intangibles. Not only do such checks help vendors measure the validity of their IP portfolios (thus preventing delays during sale and costs post-sale), they also help to identify IP that is no longer part of the company's strategic plan and hence potentially available for sale.

Monetising IP

At a recent *Financial Times* conference on Innovation, Matt Bross, chief technology officer at British Telecom (BT), revealed that approximately 80% of BT's effort is focused on hybrid and derivative partnerships, which ultimately equates to both in- and out-licensing arrangements.

The media's perception of licensing is that it's simple – even for intellectual property – surely it's just a case of a strong contractual agreement with all parties concerned? In reality, this isn't the case and, as key IP industry figures commented at the European IP Summit in Brussels in December 2006, each licensing agreement is deal-specific.

It is exactly because of this that carrying out practical checks on potential patent and trademark licenses is advantageous – particularly if the piece of technology that you are in-licensing will be a fundamental part of the product you intend to take to market (eg, Intel and computers).

Although the valuation of IP will play a part in licensing negotiations, it is prudent to check the validity of the patent, including up-to-date and continuing annuity payments. Quick and easy data verification can reassure a licensee that the patent is in order and that the owner is paying the appropriate renewals. Surprisingly, there have been cases where companies have thought they were paying a patent annuity for a successful product, but, in fact, due to typographical docketing errors, the annuity being paid was for someone else's patent; as a result, their own patent had lapsed.

Many experts recognise that the two key considerations in patent licensing should

always be: is the patent valid and is a multi-million dollar company infringing the patent?

Changing faces

Intellectual property has the potential to provide companies with a new lease of life, but it needs to be treated with care to achieve optimal performance. In the IP arena, whether buying, selling or licensing, IP professionals need to make sure they equip themselves with the right tools.

Providing CEOs and CFOs with the IP information they need to make sound strategic decisions is now an essential part of an IP adviser's role. The need to reduce risk across all areas of business is indispensable in a fast-changing economic environment and this also means that the role of the IP professional has to evolve.

Due diligence isn't just something you do as part of large M&A project, it needs to be considered for isolated sale, purchase or licensing deals to ensure success. And whatever view the media have of IP, it is definitely not something to be *blasé* about. ■

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Sample due diligence: domain names

Type	Description	Result
In force checks	Legal status and maintenance fee checks.	Helps to assess the status of the IP.
Freedom to operate search	Identify obstacles and barriers to entry of a product in a jurisdiction or to the use of a specific domain name.	Helps to understand the rights to be able to make, sell and/or use the company's products or services.
Litigation search	Check for infringement lawsuits on domain names, using public databases (via WIPO/ICANN).	Helps to determine the limitations of rights being acquired.
Domain name audit	Looks at whether the domain name is ccTLD, gTLD. Also assess the composition of the URL.	Helps to determine the strength of the URL – whether it will be easily remembered etc.
Web traffic	Looks at how frequently the domain name is visited.	Can help to determine the value of the domain name and whether it is recognised or whether it receives incidental traffic.
Title verification general title clearance	Check all domain names have been assigned correctly in all countries.	Helps to determine whether the company owns all the rights in all the countries it says it does and whether title is correct.

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