Preparing for Your Company's Future - Defensive IP Due Diligence

By: Kristin L. Murphy, Shareholder, Brooks Kushman P.C.

In today's technology-driven world, businesses of all sizes appreciate that intellectual property ("IP") is often a key asset in driving value of a company. The task of identifying the value of those IP assets in a business transaction is referred to as "due diligence." Offensive IP due diligence is done by the purchasing, investing or in-licensing entity, and is designed to identify issues that may reduce or adversely impact a perceived value of the IP. In contrast, defensive due diligence is done by the selling or out-licensing entity, with its goal being to place and justify to a purchasing entity, a value of the IP assets involved in the transaction.

Unfortunately, all too often businesses put off IP due diligence until the middle of a transaction. However, with sufficient planning, defensive due diligence may uncover opportunities to actually justify an increased value of the IP assets, as well as identify potential value limiting issues that can be addressed well in advance of a transaction. This article focuses on tips and strategies for undertaking an effective defensive due diligence.

A. Getting Your Priorities Straight

Before undertaking any due diligence, the "first order of priority" is to identify the business' priorities with respect to the transaction. The answer to some basic questions at the outset will assist in focusing the framework for the IP due diligence. In practice, in assessing business priorities, those most knowledgeable about the business meet with IP attorneys so the IP attorneys can understand the business, its products, potential competitors or potential strategic allies, and the purpose behind the transaction. In some organizations, the key business people to answer these questions may be the president of the organization. In others, the lead engineer or chief technical officer may be the appropriate person to interview.

An example of a priority setting question would be, what is the nature of the transaction that your company is pursuing and what IP will likely be involved? If the business priority is to for the entire business to be acquired, then all IP owned by the business is in play. In this instance, a person familiar with the entire organization, its assets and the industry as a whole would be an appropriate interviewee on behalf of the business. In contrast, if the business' goal is to spin-off a business segment, the focus will be much narrower, and may include the chief technical people most familiar with that segment of the business.

Another example of a priority setting question is, how important is the IP to the contemplated transaction? In other words, is IP driving the contemplated transaction or is it simply part of the package? In the biotech world, often the patent assets are a key driver of a business transaction, especially in the early stages of a company where a product has yet to be commercialized. Thus, the technical people familiar with the inventions developed by the business, as well as what patent applications are in the works, may be the appropriate persons to meet with. In contrast, for an established company with products in the market, the IP may be important, but the on-going business concern is the key driver. Thus someone familiar with the commercial products and the marketing of those products may be more appropriate to assist in this phase of the due diligence.

B. Look Under the Microscope, Before the Other Side Does

Once the business priorities have been identified, the substantive analysis begins. For those transactions involving the complete or partial sale the business, typically this process starts with 1) an identification of the goods and services being sold, as well as 2) IP that relates to those goods and services.

While the identification of goods and services to be sold is fairly straight forward, the IP identification is more complex. This step in the analysis focuses on first identifying what IP the company owns (or has rights to under license agreements). However, if there is no dedicated IP manager for the business that keeps track of such information, collecting this information can sometimes be challenging and involves consultation with the business' outside law firms (sometime multiple firms), as well as ownership searches at various patent and trademark offices. Typically an IP attorney will use a checklist designed to seek out various types of IP that the business may have rights to, just to make sure that all of the relevant IP is identified.

Oftentimes the first threshold issue that arises is ownership. For example, in a start up company, there may be a patent at issue, but no assignment from the inventors to the business was ever recorded at the patent office. Thus, at first blush, it appears that the business does not even own the patent. In this defensive due diligence phase, well before any transaction, this issue can easily be addressed. In another scenario, the business may have some rights to patents through a licensing agreement for a specific field. There may be an opportunity to broaden the field (especially if the business priority setting stage identified a company in a particular field), thereby increasing the potential value of the license in a business transaction.

Once the goods and services are identified, the IP attorney will examine the IP thoroughly to make sure that the IP actually protects the products and/or services that are being sold. For example, do the business' patents actually protect the commercial embodiment of the medical device being sold in the market? As patent applications are filed long before commercialization is complete, it is not unheard of for a patent to issue that fails to cover key features of the commercial embodiment. However, if there are still applications pending during the defensive due diligence process, there may be an opportunity to file additional applications to ensure that key product features are protected. As another example, are the trademarks at issue actually being used in connection with the recited goods and services identified in the registration? Or are there other goods or services that should be identified? Again, with enough planning, this issue can be addressed.

Even if a patent covers a commercial embodiment, its value in a business transaction may be limited if the scope of protection afforded by the patent is relatively narrow. The IP attorney will assess how easily competitors can avoid infringement of key patent claims. Again, if the defensive due diligence is performed early enough, there are some procedures available that would allow amended, and potentially broader, claims to be pursued.

However, sometimes really broad patents signal another potential concern – validity issues. As part of any IP due diligence analysis, the validity of the patents at issue must be assessed. Such an assessment includes evaluating whether or not the patent claims are novel and non-obvious in light of known prior art, and making sure that the patent itself satisfies formal requirements such as a sufficient written description and enablement. While there are proactive steps that a patent owner can take if there are concerns about validity to re-focus the claims and address potentially invalidating prior art, these activities take time and are tasks that the business will not have time to utilize in the middle of a transaction.

Another part of the substantive review is making sure that the patent assets are enforceable. Enforceability in the U.S. centers on whether the inventors, the owners of the patent and their attorneys complied with the U.S. Patent Office's "duty of candor" requirement. Typically this issue arises in the context of prior art that was known by someone involved in getting the patent, but not disclosed to the patent office. Certain administrative procedures may be done at the patent office to have this prior art considered, even after a patent has been issued, but time will be an issue.

Even if your business has great IP assets, there is still another component to consider – will the prospective buyer be able to provide the selling business' goods and services without infringing another's IP assets? In a due diligence, this process is typically referred to as a "freedom to operate" analysis. A freedom to operate analysis involves identifying any potential infringement challenges that may stand in the way of exploiting the business' products and services. In other words, are there any valid and potentially infringed patent claims that could create legal issues? If these issues are located early enough, some design-around options may be available to avoid issues during a transaction.

Finally, in reviewing the IP assets through the lens of the business priority, gaps in protection may become visible. Without the pressure of an on-going deal, additional intellectual property coverage can at least be applied for, with a specific target in mind, thereby enhancing the total value of the IP assets.

C. Putting the Puzzle Together

In a defensive due diligence, once the IP assets are thoroughly reviewed and cataloged, the intangible IP assets can be translated into a quantifiable value (with the assistance of accountants). Notably, however, if the defensive due diligence uncovers potential issues that could be exploited by a purchasing party for lowering the value of the IP assets, this process will provide time for proactive measures designed to not only address those issues, but rather to enhance the value of the IP assets.