Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=271d437b-2ec8-42e5-9ddb-f5b4290ec0e1

As a business or investment professional involved in mergers and acquisitions ("M & A"), are you conducting patent due diligence according to the standard practices of your M & A attorneys and investment bankers? When patents form a significant aspect of the value of the transaction, you are probably getting incorrect advice about how to conduct due diligence. The due diligence process must take into consideration the competitive patent landscape. If competitive patents are not included in your vetting process, you may be significantly overvaluing the target company.

In my many years of intellectual property and patent experience, I have been involved in a number of M & A transactions where patents formed a significant portion of the underlying value of the deal. As the patent specialist on these transactions, I took direction from highly compensated M & A attorneys and investment bankers who were acknowledged by C-level management to be the "real experts" because they completed dozens of deals a year. To this end, we patent specialists were directed to check the following 4 boxes on the patent due diligence checklist:

- Are the patents paid up in the Patent Office?
- Does the seller really own the patents?
- Do at least some of the patent claims cover the seller's products?
- Did the seller's patent attorney make any stupid mistakes that would make the patents difficult to enforce in court?

When these boxes were marked "complete" on the due diligence checklist, the M & A attorneys and investment bankers had effectively "CYA'd" the patent issues and were free from liability relating to patents in the transaction.

I have no doubt that I conducted my patent due diligence duties highly competently and that I, too, had "CYA'd" myself in these transactions. However, it is now evident that the patent aspect of M & A due diligence basically conformed to someone's idea of how not to make stupid mistakes on a transaction involving patents. In truth, I never felt quite comfortable with the "flyover" feel of patent due diligence, but I did not have decision rights to contradict the standard operating procedures of the M & A experts. And, I found out just how incomplete the standard patent due diligence process is when I was left to pick up the pieces of a transaction conducted according to standard M & A procedure.

In that transaction, my client, a large manufacturer, sought to expand its non-commodity product offerings by acquiring "CleanCo", a small manufacturer of a patented consumer product. My client found CleanCo to be a good target for acquisition because CleanCo's product met a strong consumer need and, at that time, commanded a premium price in the market. Due to strong consumer acceptance for its sole product, CleanCo was experiencing tremendous growth in sales and that growth was expected to continue. However, CleanCo owned only a small manufacturing plant and it was having difficulty in meeting the growing needs of the market. CleanCo's venture capital investors were also anxious to cash out after several years of continued funding of the company's somewhat marginal operations. The

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=271d437b-2ec8-42e5-9ddb-f5b4290ec0e1

marriage of my client and CleanCo thus seemed a good match, and the M & A due diligence process got underway.

Due diligence revealed that CleanCo had few assets: the small manufacturing plant, limited but growing sales and distribution and several patents covering the sole CleanCo product. Notwithstanding these apparently minimal assets, CleanCo's asking price was upwards of $150 million. This price could only mean one thing: CleanCo's value could only be in the potential for sales growth of its patented product. In this scenario, the exclusive nature of the CleanCo product was properly understood to be fundamental to the purchase. That is, if someone could knock-off CleanCo's differentiated product, competition would invariably result and ll bets would then be off for the growth and sales projections that formed the basis of the financial models driving the acquisition.

Taking my instructions from the M & A attorney and investment banker leaders in the transaction, I conducted the patent aspects of the due diligence process according to their standard procedures. Everything checked out. CleanCo owned the patents and had kept the fees paid. CleanCo's patent attorney had done a good job on the patents: the CleanCo product was covered well by the patents and there were no obvious legal errors made in obtaining the patents. So, I gave the transaction the thumbs up from the patent perspective. When everything else looked positive, my client became the proud owner of CleanCo and its product.

Fast forward several months . . . . I began to receive frequent calls from people on my client's marketing team focused on the CleanCo product about competitive products that were being seen in the field. Given the fact that more than $150 million was spent on the CleanCo acquisition, these marketing professionals not surprisingly believed that the competitive products must be infringing the CleanCo patents. However, I found that each of these competitive products was a legitimate design-around of the patented CleanCo product. Because these knock-offs were not illegal, my client had no way of getting these competitive products removed from the marketplace using legal action.

As a result of this increasing competition for the CleanCo product, price errosion began to occur. The financial projections that formed the basis of my client's acquisition of CleanCo began to break down. The CleanCo product still sells strongly, but with this unanticipated competition, my client's expected margins are not being made and its investment in CleanCo will take much more time and expensive marketing to pay off. In short, to date, the $150 Million acquisition of CleanCo looks to be a bust.

In hindsight, the competition for the CleanCo product could have been anticipated during the M & A due diligence process. As we found out later, a search of the patent literature would have revealed that many other ways existed to address the consumer need addressed by the CleanCo product. CleanCo's success in the marketplace now appears to be due to first mover advantage, as opposed to any actual technological or cost advantage provided by the product.

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=271d437b-2ec8-42e5-9ddb-f5b4290ec0e1

If I knew then what I know now, I would have counseled strongly against the expectation that the CleanCo product would command a premium price due to market exclusivity. Rather, I would demonstrate to the M & A team that competition in the CleanCo product was possible and, indeed, highly likely as revealed by the myriad of solutions to the same problem shown in the patent literature. The deal may still have go through, but I believe that the the financial models driving the acquisition would be more reality-based. As a result, my client could have formulated a marketing plan that was grounded in an understanding that competition was not only possible, but also likely. The marketing plan would then have been on the offense, rather than on the defense. And, I know that my client did not expect to be on the defense after spending more than $150 million on the CleanCo acquisition.