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Avoiding Repricing Pitfalls

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Perhaps it is no more than a result of a very active, if not somewhat frothy, auction market, but people are commenting that repricing seems to be occurring more often than usual. To the extent this is even accurate, there are many factors that could be contributing to the cause, such as continuing economic uncertainty or unevenness of economic recovery. A possible factor that is rarely mentioned but is perhaps particularly relevant is the effect of a decline in sell-side due diligence.

Rather inadvertently, many sellers have gotten out of the practice of doing a proactive due diligence review of a company prior to its marketing. Such a review previously often happened as part of assembling the diligence materials for a company. The evolution of electronic data rooms has obviated the need for physically gathering and reviewing diligence materials prior to granting access to the buyer. Many investment banks also offer, as part of their services for their fee, to gather diligence materials and prepare data rooms, and often must fit that effort piecemeal into moments of availability in the marketing process. The largely coincidental result is that sellers are engaging in less considered review of their diligence materials and issues prior to marketing.

The view that "the facts are what they are" has an undeniable tautological correctness. However, the extension of that perspective to "it therefore does not matter how the diligence is assembled or furnished" is not an equally immutable truth. Rather, experience shows the exact opposite to be true—avoidable missteps in diligence can affect auctions and negotiations.

Issues that can be detected through closer diligence review early in the process often include problems that are essentially cosmetic, i.e., issues that should not necessarily affect the value or attractiveness of a company. Examples include unexecuted customer or employment agreements, inaccurate accounts of owned intellectual property, board minutes that do not reflect current officer or director elections, inaccurate capitalization tables or missing stock certificates, failure to refresh title on owned property and failure to be in good standing.

Although these comparatively inconsequential issues can ordinarily be inexpensively and quickly remedied, when discovered during the buyer's diligence, these problems can produce a general discomfort regarding the overall operations of a business, undermining the perception of a tightly run organization. Additionally, while the buyer's lawyers may recognize the superficiality of such issues, their investigation and correction take time, and, by necessity or through buyer's artifice, impede a deal's momentum to the likely detriment of the process and pricing. These issues also can provide a smoke screen for a buyer in negotiating the coverage of reps and scopes of indemnities.

Substantive issues, on the other hand, can create legitimate concerns regarding value and undermine deal terms. These problems may not be easily resolved and may simply be a negative aspect of the company or its business. Existing environmental liabilities and active litigation are common examples of such issues that sellers usually recognize and deal with upfront so that they do not disrupt an auction.

Other similar problems are less obvious, such as agreements with unfavorable exclusivity provisions, agreements with most favored nations or other unfavorable pricing terms, underfunded pension plans and lack of proper employee I-9s. These often are not apparent to a seller but usually will be discovered by a comprehensive diligence review on behalf of the buyer or the seller. Early detection allows the seller to accurately position the company during the initial bidding process and to reduce buyers' ability to raise concerns about the validity of bid prices late in negotiations.

Many significant issues nevertheless can be corrected or mitigated if discovered on behalf of the seller. For example, one common substantive obstacle arises when missing links in the chain of title for intellectual property are exposed; the problem can be investigated and usually resolved. Similarly, by running lien searches, outdated financing statements can be identified and removed. Analyses of downside exposure of contracts or relationships with adverse termination rights can be prepared. Certain health regulatory compliance issues can be addressed by implementing compliance programs. The cost to remedy or ameliorate the issue is invariably less if such correction is done internally than if it is later done with the buyer's knowledge and involvement.

The causes behind the trend away from sell-side preparatory due diligence are easily identified; the consequences perhaps less so. However, those consequences are at least a contributor to or an excuse for some of the adverse developments in auctions. What might be appropriate sell-side diligence should be considered in each case, but given the cost of processes and prices of doing little or nothing, the money and time saved by not doing any preparatory diligence may be truly penny wise and pound foolish.

America Invents Act – Practical Considerations for Portfolio Companies

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Private equity funds should familiarize themselves with recent changes to U.S. patent law that affect patent protection strategies for their portfolio companies. In September 2011, the U.S. Congress enacted the America Invents Act (AIA) patent reform bill, which significantly overhauled U.S. patent law. This article summarizes practical considerations that private equity funds should bear in mind when evaluating and managing the patent portfolio of their investments.

First Inventor to File

In the broadest sense, the AIA converts U.S. patent law into a "first-inventor-to-file" system from a "first-to-invent" system. This conversion harmonizes U.S. patent law with the rest of the world's patent laws. In practice, it means that businesses should not delay filing patent applications, as they can no longer antedate patent-defeating prior art with an earlier invention date.

Challenges to Patent Rights

Effective September 12, 2012, the AIA provided businesses new post-issuance patent validity challenge options that may be exercised before the U.S. Patent and Trademark Office (USPTO). The new post-issuance challenges provide businesses new and predictable avenues to test the validity of a competitor's patent that is, or may in the future be, an impediment to commercialization. These post-issuance challenges include post-grant review, inter partes review and the Transitional Program for Covered Business Methods. Each of the three post-issuance challenges is defined briefly here.

Post-Grant Review

Someone other than the patent owner may file a petition for post-grant review challenging the validity of a patent within nine months of the patent's date of issue or reissue on any statutory grounds for invalidity. Thus, even if a patent has been grated to a portfolio company, it may be subject to challenge by third parties in the time period immediately following issuance. Similarly, a portfolio company could elect to challenge a competitor's rights, even after a patent has been issued.

Inter Partes Review

Someone other than the patent owner may file a petition for *inter partes* review challenging the validity of the patent nine months after the date of issue or reissue on limited invalidity grounds. *Inter partes* review may only be instituted after the time period for post-grant review has expired and offers only a subset of the challenges available in post-grant review. This means that throughout the entire life of an issued patent, generally 20 years from the filing date of the earliest priority document, it may be subject to challenge and invalidation. Private equity funds should closely consider any potential challenges that could be lodged against a portfolio company and should evaluate potential risk before investing.

Transitional Program for Covered Business Methods

With regard to business method patents, someone other than the patent owner may file a petition for covered business method review challenging the validity of a patent if (1) the petitioner has been sued for infringement or threatened with an infringement suit, and (2) the patent claims a financial product or service. Practically speaking, this scope is broader than mere financial products or services, such that any patent claiming anything related to money may potentially be challenged using a covered business method review. Versata Development Group Inc. recently filed suit against the USPTO in the Eastern District of Virginia alleging that such a scope is impermissibly broad. Until the result of that case or guidance is issued by the USPTO, private equity funds should proceed under the broad definition of "financial product or service" when evaluating a portfolio company with patents that may be challenged under the covered business method review.

Conclusion

Whether used against competitors' patents or in defense of a business' own interests, the new post-issuance challenges available under the AIA are powerful new tools in a portfolio company's strategic toolbox.

Questions concerning the information contained in this newsletter may be directed to your regular McDermott Will & Emery lawyer or you can contact the Firm at privateequity@mwe.com. For more information about McDermott Will & Emery visit www.mwe.com.

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