

Patent Valuations Before M&A Deals

By Susan Perng Pan

Intellectual property is an increasingly important factor in mergers and acquisitions, but the value of IP remains difficult to assess. Perhaps that explains the dramatic disparity observed in a recent study by the

Mergermarket Group. It found that even though eighty-five percent of corporations consider IP assets as important or more important than other corporate assets in M&A deals, only thirty-two percent investigate IP value in depth before completing these deals.

It is true that a rudimentary value can be placed on patent assets. Like the value of any asset, it rises and falls with economic tides. Standard valuation tools include the 25 percent method, which assigns approximately 25 percent of a company's operating profits to its patent holdings; the income method, which evaluates a patent as a present value of a future income stream; the market method, which evaluates patents relative to similar patents; and the cost method, which assigns values as

the cost of designing alternatives for patented technology. However, the unique character of intellectual property makes standard application of these valuation tools extremely difficult.

For companies positioned to invest in new mergers and acquisitions, it is possible to find good technology deals in the current patent marketplace. It is akin to finding distressed real estate in need of renewed financial backing. The latent question is whether the acquisition represents a true financial value in addition to being a strategic one. For companies seeking to sell the whole or parts of its technology business to relieve financial stress, the difficulty and flexibility inherent in IP valuation can be used as leverage in setting a purchase price.

The first step for purchasers is to identify a target, or preferably multiple targets, operating in the same technology area. Present economic conditions have forced some patent holders to abandon their patent applications which lie along the fringes of their core business areas and/or to give up pursuing patents for lack of funding. Such signs of distress open the doors for acquisition opportunity, not for the abandoned assets themselves, but for the entities which allowed such abandonment.

Once targets are identified, consider the relative strength of their patent holdings. If one of the patent portfolios appears weaker, then that target's latent value is lower, and this point can be leveraged during negotiations.

This raises the question of how to determine relative strength and weakness. The value of a patent portfolio lies in its potential to either generate revenue or exclude competitors from the technical estate defined by its patents. If due care is

name implies, a pioneer patent is the patent on the most basic technology, thereby allowing target A to extract a royalty payment from virtually all companies in a particular technology area.

The pioneer patent, alterna-

PURCHASER LEVERAGE IS INCREASED IF THE PATCHWORK OF PROTECTION IS HELD BY OTHER POTENTIAL TARGET COMPANIES, AND MORE SO IF THE PATCHWORK OF IMPROVEMENT PROTECTION IS HELD BY THE ACQUIRING COMPANY ITSELF.

not taken to preserve that potential while prosecuting the patents in the U.S. patent office, the portfolio value easily becomes deflated.

In the licensing context, there is a notable gap between the highest and lowest license rates for patents. This gap is observed in all market sectors. The total amount that a potential licensee would pay for licensing a portfolio necessarily depends on two factors: (1) the size of the market and (2) the risk involved in the transaction. Both of these factors must take into account legal considerations underlying the patents to provide reasonable assurances of fair value.

The first component, the size of the market, will be defined by the amount of product revenue that falls within the technical estate afforded by the patents. It's more or less dependent on prevailing market conditions. The second component, risk — meaning, in this context, probability of infringement — can be evaluated by analyzing the underlying legal document.

Relative legal strength of a portfolio can be assessed in terms of protection of basic technology and improvement technologies. As one example, acquisition target A may hold a pioneer patent. As its

tively, allows target A to exclude other market entrants from operating within the sphere of the patent. The value of a pioneer patent obviously is highly important in the assessments made as part of an M&A decision. However, possession of a pioneer patent does not place all the leverage in the hands of target A. Since most high technology companies do not rely on any single patent to secure their market position, it is important to view the patchwork of patent protection that a target company has accumulated against that of another acquisition target.

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The patchwork or “improvement” patents may be held by entities other than target A. If the holder of the pioneer patent does not have a patchwork of protection surrounding the basic technology, then the monopoly power of the target A patent portfolio will quickly fade. This factor allows leverage to swing back into the hands of the purchaser.

This leverage is increased if the patchwork of protection is held by other potential target companies, and even more so if the patchwork of improvement protection is held by the acquiring company itself. Incidentally, an investigation that includes multiple targets also will shed light on the question of whether an acquisition will have the detrimental effect of buying into a patent infringement suit.

An acquiring company can argue for lower assumed patent value during negotiations by noting that the full value of any patent will extend over its legal life. Thus the net present value of the patent will be significantly diminished. Net present value calculations can also be adjusted relative to the timing. If the value of the patent offers an early entry to the market and the value of the market relies on present entry, then the patent holder stands in a better position to demand a larger payment.

An early entry to market may be particularly valuable in areas such as pharmaceuticals, where demand is not tied to consumer discretionary spending. In contrast, in the current economic climate the potential for immediate entry to market may be less valuable in a technology area

that relies on discretionary consumer spending. In addition, the patent value has a significant present value when the typical product life cycle is compact in comparison to the situation where the product life cycle is longer.

Another component of patent value relates to the marketing strategy of the product covered by the

patents. For example, if an acquisition target has traditionally bundled a small component of its patented technology with an overall system, then this would tend to increase the value of its patents. If, on the other hand, the target relied on piecemeal marketing of its patented product, the overall value of the patents for that product tends to be diminished.

Even without a marketing campaign, if a patented product bears a functional relationship with non-patented products, this would also tend to increase the intrinsic value of a patent portfolio. For example, if a patented processor component functions with a particular server or host environment, then the value of the processor component alone may be conveyed with the larger overall system, thereby increasing value. The lack of such a functional relationship would have the opposite effect.

In addition to these factors of

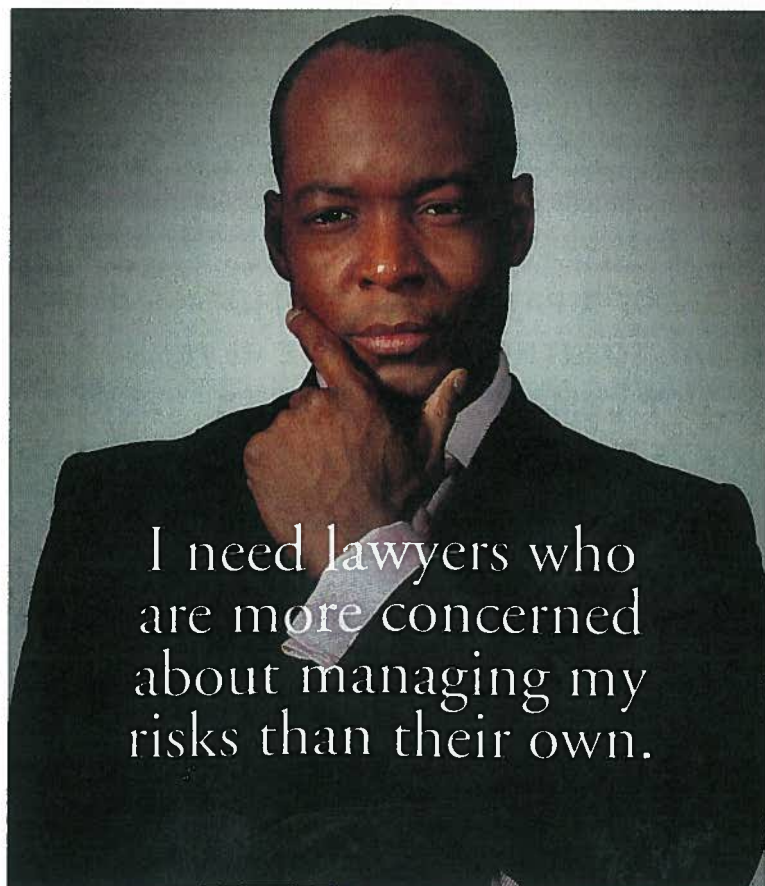
portfolio scope, breadth, timing, duration and relationship to related products as discussed above, an acquiring entity should never overlook administrative issues. These include verification of proper ownership of the patents, whether the patents' maintenance fees have been kept up to date, whether all possible validating information has been considered by the U.S. Patent Office, and whether the filing dates for the patents have been properly preserved. These basic inquiries should be part of any patent due diligence, whether in the context of M&A or receiving the assets of a bankrupt entity.

The above analyses highlight the nature of patents as merely another form of property. Some basic issues, such as title and legal viability, should be cleared before possession is even attempted. Deeper inquiries need to be investigated to ensure that a patent or set of

patents will be suitable for a company's needs, and if so, what cost would be justified. Despite their inherently unique character, patent portfolios can be analyzed in ways that will illuminate their strengths and vulnerabilities, and thus help set an appropriate negotiating point in merger and acquisition transactions.



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