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# The Evolving Role of IP in M&A: From Deal-Breaker to Deal-Maker<sup>1</sup>

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BY RON LAURIE

## PERSPECTIVE

Over the past several years, patents have come to be recognized by the financial community not just as a bundle of legal rights, but as an independent commercial asset class, like real estate and corporate securities. Innovative new models for monetizing patents have emerged based on the creative adaptation of existing models used with more traditional asset classes such as asset-backed securities and more traditional strategic models.

“This shift in perception about the uses and the value of patents,” says Ron Laurie, an IP investment banker and former patent attorney who focuses on transactions, “has spawned a proliferation of market makers, intermediaries, and service providers, including patent aggregators, enforcers, investors, financiers, brokers, exchanges, and auction houses.

“New business models are emerging every day. More recently, institutional investors, in the form of private equity firms and hedge funds, have come to see investing in patents, or in patent litigation, or trading public company shares based on patent-related information, as a natural expansion of their existing business.”

Laurie contends that the shift in perception regarding IP assets has until now had little, if any, impact, on corporate mergers and acquisitions. The reasons are both structural and environmental, and derive in

*(continued)*

large part from the problem of corporate valuation, especially when it involves intangible assets. IP was traditionally viewed in M&A transactions as a possible “deal-breaker,” effectively an afterthought that IP lawyers attended to. When it came to consummating a transaction, these professionals were much more likely to regard all news as bad news. Today, IP in M&A is starting to be seen as an important deal facilitator that the bankers, private equity capital providers, and others need to understand from the start.

## NOT JUST A BUNDLE OF RIGHTS

It's no secret that there has been a fundamental shift in the way that business and financial communities view intellectual property, especially patents. Patents have been seen historically as exclusionary legal rights, which give their owner the ability to exclude competitors from particular markets (via injunction); to tax competitors for the privilege of participating in those markets (via license fees); or to force them to “design-around” the protected subject matter. Over the past five years or so, however, patents have come to be recognized not just as a bundle of legal rights, but an independent commercial asset class, like real estate and corporate securities. Innovative new models for monetizing patents have emerged based on the creative adaptation of existing models used with more traditional asset classes.

This shift in perception about the uses and economic value of patents has spawned a proliferation of market-makers, intermediaries, and service providers, including patent aggregators, enforcers, investors, financiers, brokers, exchanges, and auction houses, and new business models are emerging every day.<sup>2</sup> More recently, institutional investors, in the form of private equity firms and hedge funds, have come to see investing in patents, or in patent litigation,<sup>3</sup> or trading public company shares based on patent-related information,<sup>4</sup> as a natural expansion of their existing business.

There is one area of business activity, however, in which this shift in perception has had little, if any, effect—the world of corporate M&A (mergers and acquisitions). There are a variety of reasons for this, some of which are structural and derive from the intrinsic nature of intangible assets and others of which result from environmental factors relating

to the way that the management of the M&A process has evolved. By far, the most significant impediment has been the inherent difficulty in valuing intangible assets, and in particular the intellectual property component of corporate value. This chapter will examine some of these challenges, and suggest possible ways to more effectively integrate IP into the value calculus in mainstream M&A activity.

## **FIRST GENERATION M&A MINDSET: IP AS A DEAL-BREAKER**

For decades, the role of IP analysis in M&A transactions has been limited to the identification and allocation of IP-related risk. Foremost among these is actual or prospective third-party infringement litigation that presents the threat of substantial monetary damages exposure, or worse yet an injunction that shuts down a product line or an entire business. Other IP-related risk factors include the potential loss of a critical inbound license upon sale or change of control of the target company, clear title defects such as jointly owned IP, or third-party ownership claims based on the absence of critical employee or consultant invention assignment agreements, and compulsory licensing obligations arising from participation in industry standards organizations. The risk identification process is referred to as “IP due diligence,” and risk allocation is achieved through a combination of contractual provisions including representations and warranties, (with attached knowledge qualifiers and materiality thresholds), closing conditions, indemnification, escrow of some portion of the purchase price, and other risk shifting mechanisms.

In this model, the primary mission of the acquirer’s IP diligence team is ultimately to advise the company if they find any risk factor that is so significant that the acquirer should consider aborting a deal that has already been agreed upon, both as to overall structure (e.g., reverse triangular merger, forward merger, asset sale, stock sale, etc.) and, more importantly, in terms of valuation, (i.e., purchase price). Thus, the focus is almost entirely on IP risk and not on IP value, and the role of the IP analysis is solely that of a potential “deal-breaker.” (It is a relatively rare occurrence where the discovery of a previously unknown IP-related risk causes the parties to revisit, and adjust, the deal price.) In this context, IP diligence should be contrasted with technology diligence, where

substantial resources are devoted to analyzing the expected synergies and efficiencies in combining the technologies and associated markets of the target company with those of the acquirer, and those synergies or efficiencies are then translated into, or at least validate, the deal price.

As mentioned above, the reasons for this lack of attention to IP in deal pricing fall into two categories: structural and environmental. The most important structural factor is the perceived inability on the part of the companies involved in the transaction, and their investment bankers and accountants, to accurately calculate (or even estimate) the IP component of the target's corporate value. Most of the traditional metrics used to value companies simply don't apply to intellectual property assets.<sup>5</sup> These valuation methodologies come from two sources: valuation of tangible assets such real property or industrial equipment, and valuation of businesses.

Tangible asset valuation methods, such as the cost, income, and market approaches have been "ported" to IP assets with little success. The cost of developing a noninfringing substitute for patented technology may have little relevance to the true value of the patents in question. The net present value of the predicted future income stream(s) attributable to the patents in question (aka discounted or risk-adjusted cash flow) may be entirely speculative, especially in the absence of past earnings attributable to those patents. With regard to the market approach, patents tend to be unique and largely nonsubstitutable, and therefore a "comparables" analysis, while often providing some useful data points on value, cannot be relied upon to the same degree as with real property, industrial equipment, antiques, fine art, or classic cars because the inherent uniqueness of patents makes the notion of a comparable patent, or patent portfolio, elusive at best. The inherent difficulty of using comparables to value IP is compounded by the fact that historical transaction (price) data for patent sales, as opposed to licenses, is very hard to come by because purchasers view their IP buying strategies as highly confidential. This will be discussed further later in the chapter.

As to existing methods of valuing companies, the traditional accounting performance metrics such as EBITDA, free cash flow, debt/equity ratios, and, in the case of public companies, market cap and price/earnings multiples, are inherently retrospective. That is, they are based largely on historical performance, and on the fundamental assumption that past performance is a reasonably good indicator of future success. Thus, from

an accounting perspective, the value of tangible assets and of going-concern businesses, and the predicted future income streams that they will generate, is based on looking in the rear-view mirror. Alternatively, the intrinsic value of intellectual property assets depends, for the most part, on future events. This is especially true for the most valuable of all IP assets, patents covering breakthrough or disruptive technologies with no history of commercialization and financial return, but which turn out to cover “the next big thing.”

Another difficulty in valuing patents is that their true value is heavily dependent on the existing patent portfolio and competitive position of the acquirer, and the use to which it intends to put the acquired patents, (e.g., strategic [increased market share via exclusion of competitors or market expansion by using IP rights as contributions to joint ventures or alliances], financial [top line revenue enhancement via licensing or cost reduction via cross-licensing], or defensive [settling or pre-empting patent attacks by litigious competitors].) This contextual aspect of intangibles valuation involves the concept of “value in use.”

There are also a variety of environmental impediments to integrating IP value analysis into corporate M&A transactions. Some of these result from the valuation challenges discussed above, while others are inherent in the M&A process itself, and from the organizational status of the IP function within most large technology companies.

If an M&A transaction can be analogized to a symphony, then the investment bankers on each side of the deal are the orchestra conductors. The “i-bankers” play a central role in coordinating among, and integrating the contributions of, the various subadvisors such as lawyers and accountants. The lawyers are in turn led by the corporate lawyers who initially structure and then “paper” the deal with the assistance of various legal specialists such as antitrust, tax, environmental, employment, and of course, intellectual property lawyers. The i-bankers, and thus the parties to the transaction, typically do not focus on IP during the early stages of M&A activity, such as target selection and deal pricing. There are several reasons for this. (It should be noted that while most large i-banks have one or more IP lawyers on staff, these IP specialists rarely become involved in the M&A process, and instead are tasked with protecting any potentially patentable techniques, methodologies, business models, or financial “products” developed by the i-bank.)

One reason that investment bankers avoid focusing on IP value in deal pricing has already been mentioned: the difficulty in valuing IP. Most of the investment bankers' compensation for M&A advisory work is paid in the form of a success fee that is contingent on closing the transaction. Thus, if at all possible, i-bankers will avoid introducing any unnecessary closing risk into a deal in the form of economic issues as to which the parties may not be able to agree. Stated more directly, the last thing an i-banker wants to see is a potential deal-killer. Because IP valuation is an art rather than a science, and in many cases, buyer and seller will have a significant difference of opinion on how much the seller's IP is really worth to the buyer, the i-bankers, and their corporate clients tend to avoid including IP in the deal price calculus because of fear of creating a price gap that can't be closed.

Another IP-related risk factor responsible for the avoidance of IP value analysis in determining corporate value may be the fear that one or more disgruntled shareholders or investors of a party to the transaction will come forward after the deal is completed, claiming (in the form of a lawsuit) either that the buyer overpaid for the IP, or that the seller received too little—or both! IP-related shareholder derivative suits and Sarbanes-Oxley litigation are relatively rare, but as the IP portion of overall corporate value continues to grow, we can expect to see more litigation based on the mismanagement of IP, including the failure to properly estimate, or to consider at all, the value of the target's IP in an M&A transaction.

Still another environmental factor may be that those who know the most about IP are typically lawyers, and because lawyers often see their primary role as identifying and mitigating risk, (i.e., protecting their clients by developing every possible worst-case scenario no matter how unlikely), there is a reluctance to let the lawyers "into the room" during the initial business discussions about price and value. In this regard, a rough analogy may be drawn to presenting a draft pre-nuptial agreement for discussion on a first date.

An additional argument sometimes heard, particularly in the case of public companies, is that IP doesn't need to be separately valued because the market has already done so, and it is reflected in the share price/market cap. As discussed above, this may be partially true for IP that can be directly linked to past earnings, but has little applicability to IP that is used strategically or defensively, or to IP covering disruptive new technologies.

Yet another justification for ignoring IP in deal pricing is that much of the target's IP may be in the form of sensitive technical information, trade secrets, and know-how, which will not be disclosed, even under NDA, until the target knows that there is a reasonable chance that a deal is possible. (This is particularly applicable where the parties are direct competitors.) While this may be true, there is often substantial IP in the form of issued patents and published patent applications, which can be reviewed early in the negotiations, and even before the target is approached. The ultimate extension of this strategy is to use IP analysis to help drive the target identification and selection processes.

Finally, there is an organizational reason why IP analysis is typically restricted to risk identification (via due diligence), and allocation (via reps & warranties, indemnity, escrow, etc). In the early stages, because of secrecy concerns, the corporate deal team is restricted to a few senior "C-level" executives including the CEO, VP of Corporate Development, CTO, CFO and CLO (aka General Counsel or VP-Law). Because in most companies, including technology companies, the head of IP reports to the head of legal (the CLO), and is thus not himself or herself a C-level executive, he or she is often viewed as not senior enough to be made aware of the prospective transaction, at least until the due diligence process begins. This will be discussed further later in the chapter.

## **SECOND GENERATION M&A MINDSET: SEEING IP AS A DEAL-DRIVER**

While the general tendency in traditional M&A activity was to avoid any consideration of IP in pricing an acquisition, there are some notable exceptions. The first is in connection with pharmaceutical and biotech companies where patents play a critical role. One possible reason is the fundamental difference in the effect, and thus the value, of patents in the bio/pharma world, as contrasted to high technology. To oversimplify a bit, in high-tech, patents are sought that broadly protect markets, while in bio/pharma, patents generally protect products. Thus, if a semiconductor company, or electronics company or software company develops a solution to a particular problem that had not previously been solved, the company tries to protect all solutions to the same problem, regardless of the implementation details. On the other hand, if a pharmaceutical

company develops and patents a blockbuster drug for the treatment of a particular disease, and a competitor introduces a drug with a substantially different formulation that is also an effective treatment for the same disease, the former company's patent position provides no market protection (in the form of exclusionary rights) against the latter company. Because the patents are so closely tied to products, they often become an important element of company valuation. Another difference is that the patent invalidity risk due to unknown prior art, and thus the valuation uncertainty, is much lower for a new molecule than for a software architecture for network control that is claimed by its developers to be novel and nonobvious.

The second exception to the general rule of not considering IP value in M&A deal pricing is where there isn't anything else to value. A dramatic example in this category, in which the author was involved, was the sale of a company named InterTrust in November 2002. Since 1990, InterTrust had been pioneering the development of DRM (digital rights management) software for securely distributing high-value digital content (such as software, music, and movies) in a way that integrated a payment mechanism into the distribution system. The initial distribution mechanism was via encrypted CD-ROMs, but that changed with the arrival of the Internet (more precisely the World Wide Web) around 1993. (IBM and Xerox had also been developing products in this area for some time.)

InterTrust had gone public in 1999, and at the height of its product development efforts, the company employed nearly four hundred people. By the time of the sale of the company, there were only a handful left. This decline was due partly to the collapse of the Internet bubble, partly to the fact that the DRM market did not develop as quickly as expected, and partly to Microsoft's anticipated dominance in this area. InterTrust had yet to introduce a product, and thus there was no earnings history (EBITDA) on which to base company valuation. In fact, at the time of the sale, the only assets were: a patent portfolio covering a wide range of different DRM implementations comprising 26 issued U.S. patents and 85 pending patent applications around the world, and a patent infringement lawsuit against Microsoft based on 11 of those patents.

InterTrust's board of directors and senior management decided to reposition the company from a product company to an IP licensing company and sell the company to a major corporate player that was, or

wanted to be, in the DRM space. Several large investment banks initially contacted by InterTrust passed on sell-side representation of the company because of the lack of earnings history and absence of any “real” assets, and because of their inability to value the patents and the law suit against Microsoft. Ultimately, one of the smaller investment banks, Stephens Bank, accepted the representation and InterTrust was ultimately sold to a joint venture formed by Sony, Philips, and Stephens for \$453 million! This was a highly strategic acquisition for Sony, which was planning to turn its PlayStation 3 game console into a full-fledged digital content delivery—and transaction payment—device, in direct competition with Microsoft’s Xbox 360.

In July of 2003, eight months after the sale of InterTrust was announced, the judge in the patent suit against Microsoft, in a so-called Markman ruling, adopted InterTrust’s patent claim construction, and nine months later, the suit was settled on the basis of Microsoft’s payment of a one-time license fee of \$440 million (just a shade under the acquisition price of InterTrust).

After InterTrust, there could be no doubt that patents having significant strategic value, in terms of providing competitive market position, could be used to source a substantial M&A deal. This transaction signaled that the role of IP in the M&A world had indeed transitioned from a potential deal-breaker to a deal-driver.

## REMAINING IMPEDIMENTS TO FULLY INTEGRATING IP VALUE ANALYSIS INTO M&A TRANSACTIONS—AND POSSIBLE SOLUTIONS

As discussed above, the primary reason that IP value is typically not considered in pricing M&A deals is the lack of reliable methodologies to translate a company’s IP position into quantitative economic terms. While the income approach—which seeks to estimate the risk-adjusted net present value of incremental future income attributable to the IP—may provide some useful data, by far the best indications of value are recent transaction prices for the sale of comparable (or at least, similar) patent portfolios. However, there are two problems with using “comp” data to value IP: first, the almost total absence of publicly available purchase price data; and

second, even if the data were available, the analytic challenge of determining what is, and what is not, a comparable patent portfolio and/or transaction. The good news is that there are solutions to both problems on the horizon.

The primary reason that patent sale transaction data is hard to find is that one or both of the parties to the transaction, most often the buyer, wants it that way. If it were widely known, a company's patent purchasing activity would provide a window of competitive intelligence into the purchaser's market and product strategies. Thus, unless the buyer is a public company and the amount paid is "material" given the size of its business, price information generally will not be available from any public source. In fact, not only is price information difficult to come by, but even the fact that a given company has purchased patents at all may be concealed through the use of a shell company. It is quite common for a buyer to take title in the name of an LLC formed for that purpose and then record the patent assignments in the applicable patent offices around the world under the name of the shell company. (Of course, if and when the patents are litigated, the true owner will likely be disclosed in discovery and may be forced to join the suit on the basis that it is an "indispensable party.")

Notwithstanding this veil of secrecy around patent sale transactions, there is one good source of anecdotal data, and it resides in the minds of the patent brokers and other intermediaries involved in the majority of these transactions. Of course, the intermediaries are almost always contractually precluded from disclosing the details of a particular transaction, but the information can be used by them to give future clients at least a rough estimate of the market value of a given patent or portfolio. And obviously, the more transactions in which a particular brokerage firm is involved, the better the estimate.

As corporate IP strategy becomes increasingly visionary and proactive (as described in the book, *Edison in the Boardroom*<sup>6</sup>), demand will rise sharply for better IP transaction information that compliments existing data services subscribed to by traditional corporate development teams involved in the M&A process. Beyond the patent intermediaries as a source of anecdotal comp data, there is currently a new effort underway to create a trusted, standardized database of patent sale information that can be used by prospective patent buyers and sellers to make better

decisions. The organization leading this initiative is Gathering2.0, based in Menlo Park, California,<sup>7</sup> and its initial members include some of the largest corporate patent buyers, and buyer/sellers, in the world, including both major technology companies and financial buyers.

Just as other markets have evolved with increasing liquidity and transparency fueled by the sharing of standardized information among participants through a trusted, neutral “informed intermediary,”<sup>8</sup> Gathering2.0 is providing such an approach at a time when demand for patent transaction information is rising. By collecting standardized patent transaction data from patent buyers and sellers, and taking certain measures to ensure that their identities remain confidential and their data submission is valid, this service will be a valuable resource for prospective buyers and sellers for comparative data and trend analysis on patent sales, and eventually all other types of IP transactions.

Gathering2.0’s standardized data set includes pricing, as well as other extremely relevant information such as the applicable technology, products or markets, the number and geographical distribution of the patents, etc. However, this data must be properly “anonymized” or it will not be made available. The obvious challenge here is balancing the need for confidentiality as to past transactions with the desire for useful information in pricing future transactions.

Addressing information-sharing in the form of “comp data” among IP market participants is a critical step in a process to more fully integrate IP value analysis into C-level corporate decision making, including M&A transactions. Certainly, other steps are needed to help improve transparency and efficiency in the transaction process. Gathering2.0 is working with several global leaders to develop other standardized “next” practices to address key IP diligence process issues including, for example, standard formats for offering documents (i.e. selling packages), dealing with encumbrances, standardizing on the right set of valuation methodologies for certain IP transaction types, appropriate time limits for due diligence, recommended reps and warranties for purchase agreements, and the like.

Collectively, the IP diligence process issues outlined in this chapter are key factors influencing the lack of liquidity; they are also creating an unacceptable level of uncertainty for valuations and the inability to predict if, and when, a deal will happen. Such inefficiencies in the diligence process are costly, as evidenced by high broker commissions (20–40%), and lead to

far more deals cratering rather than closing. However, as more corporate M&A efforts get infused with proactive, visionary IP strategies supported by reliable data, analytics, and other standardized diligence tools, the market will benefit from increased liquidity.

## THE ROLE OF THE CIPO IN EARLY-STAGE M&A ACTIVITY

As mentioned above, one of the environmental impediments to integrating IP value analysis into early-stage M&A activity, (i.e., formulation of corporate growth strategy, target selection, and deal pricing), results from the organizational status of the IP function within most large companies. Typically, the IP function is embedded within the corporate legal department, with the head of IP (variously described as Director of IP, Chief IP Counsel, or Patent Counsel) reporting to the Chief Legal Officer (who may be titled General Counsel or VP-Law). This organizational locus is suboptimal for several reasons.<sup>9</sup>

First, the primary mission of the legal department is risk management, not value enhancement. The latter role is the function of the finance, R&D, marketing, and corporate development groups within the enterprise. However, while risk mitigation is a critical element of IP management, that mission can be executed through legal department oversight, without placing the IP function within (or at least, entirely within) the corporate legal organization. There are many examples of corporate functions that involve legal risk, but are not embedded within the legal organization. For example, the human relations department deals with legal risk on a daily basis, but the head of HR does not report to the General Counsel.

Second, unless the head of IP is seen as a member of the senior management team—generally defined as “C-level” executives (CEO, CFO, CTO, etc.)—he or she will not be viewed as worthy of a seat at the table in early stage discussions of potential M&A opportunities. For example, in the author’s experience, the IP specialists in the outside law firms representing the acquirer and target frequently know about the prospective transaction before, and sometimes long before, the parties’ internal IP counsel. In M&A-speak, the corporate IP group, including the head of IP, is viewed as not senior enough to be within the small group of

key executives who are brought “over the wall” in the early stages of an acquisition, divestiture, or so-called merger of equals.

This environmental impediment will gradually disappear as more and more companies move the IP function, or at least the business-oriented parts of it, out of the legal department, and elevate the status of the head of IP to a C-level position in the form of a Chief Intellectual Property Officer (CIPO). The CIPO will become an essential member of the corporate M&A deal team and will be intimately involved in planning the company’s growth (or downsizing) strategy, in selecting and ranking potential M&A opportunities, and, once a target is selected, in pricing the deal. Even in those companies, where the head of IP continues to report to the head of legal, companies are developing informal “dotted-line” relationships between the de-facto CIPO and the nonlegal C-level executives tasked with enhancing corporate value. Another organizational variant is to keep IP litigation within the legal department but “spin-out” the value extraction aspects of IP into a separate organization or even a separate company. Early adopters of this model include Hewlett-Packard (Joe Beyers), IBM (John Kelley), AT&T (Scott Frank), and Philips (Rudd Peters).

## THE ROLE OF THE IP INVESTMENT BANKER IN EXTRACTING MAXIMUM VALUE FROM IP IN M&A TRANSACTIONS

The recent recognition of IP as a new commercial asset class means that monetization models that have developed in connection with other asset classes will be adopted, with appropriate modification, to exploit this new asset class. This has already occurred with regard to patent brokerage (which bears some striking similarities to real estate brokerage); IP collateralization (a new form of asset-backed lending); and securitization of IP royalty streams (although to date, this model has been generally limited to bio/pharma patents, music copyrights, and trademarks). The next step will be to adapt the existing M&A models employed in connection with the acquisition, divestiture, and merger of companies, and parts of companies, to encompass IP value analysis.<sup>10</sup> Enter the IP investment banker.

Two examples will now be described illustrating how an IP investment banker can either increase the acquisition price for a seller in the context of existing M&A discussions, or actually source an M&A transaction in

the first instance in the form of a corporate spin-out of “stranded” technology and associated IP, a model that can be truly characterized as “IP-driven M&A.”

When a larger company approaches a small or mid-sized technology company with a view towards potential acquisition, the conversation quickly turns to corporate valuation. For all the reasons described above, this process tends to ignore, or at least undervalue, the target’s IP position, and in particular its patents and trademarks. In this context, an IP investment banker representing the target can play an important role in refocusing the acquirer’s attention on intangible assets as an important element of the acquisition price.

One technique for achieving this shift in value perception on the part of the buyer, which this author has successfully used, is to transfer the target’s patents and trademarks to an IP development company, which may be structured as a parent or independently controlled sibling of the target. The IP holding company then licenses the patents and trademarks to the target on a nonexclusive, and possibly royalty-bearing, basis. This means that acquisition of the target does not automatically transfer ownership of the IP to the buyer, but rather only the nonexclusive right to use it, in exchange for reasonable compensation. The IP holding company is free to license the same IP to others, including the buyer’s competitors. The transfer of the target’s IP to a holding company forces the acquirer to decide whether it wants to acquire the IP as well as the complementary business assets owned by the target—in which case the IP must be separately valued and priced.

Another technique to force buyers to focus on IP value involves the use of exclusive field-of-use licenses. Suppose the target has a patent portfolio covering several distinct and nonoverlapping technologies, commercial applications, or vertical markets. Suppose further that only one of these is applicable to the prospective buyer’s current business. The buyer will certainly undervalue the patents that do not relate to its business. In this variant, the target can transfer ownership of its IP assets to a holding company, and take back an exclusive field-of-use license limited to its current business or to the business of the prospective acquirer. This will give the buyer an exclusive position in the IP for its core business, including the rights to license and to assert the patents against competitive uses, but not the right to license or sue others in different fields. This focuses the buyer on the question of whether it wishes to acquire the IP rights in fields outside of its current business. If it does, it must estimate

the incremental value of doing so, and negotiate an appropriate price for those noncore rights.

An example of IP-driven M&A involves the monetization of “stranded” technologies and related IP that exist in virtually all large technology companies. In this context, stranded technology comes in two principal forms. One of these is “noncore” technology that doesn’t fit with the owner’s current business and future road map. This type of stranded technology and IP can result from many different scenarios. It may have once been core but has become stranded as a result of a change in the owner’s business plan, technology focus, or target markets. It may have been acquired along with core assets in a corporate M&A transaction. It may have lost a powerful internal advocate that has left the company.

Regardless of why it is noncore, one thing is certain. Because it is nonstrategic, it can’t compete for R&D dollars with core technologies. Thus, if it stays where it is, its value will surely diminish over time. Once the key inventors realize that they are no longer on the main track, they will move elsewhere within the company or find another employer. This will usually have the effect of rendering the recorded know-how unusable because the people who created it are no longer around to explain it. Finally, the associated patent position will wither and possibly disappear altogether because there will be no money for follow-on applications and issued patents will lapse due to nonpayment of maintenance fees.

The other type of stranded technology and IP can be characterized as multiuse, or “multistranded.” In this case, the technology is in fact core to the owner’s business but that business represents only a fraction of the total available market in which it potentially can be commercialized. The best source of this type of stranded technology is defense contractors, where the commercial (e.g., nonmilitary/aerospace) applications of the technology may represent 90% or more of the total available market.

Under a new IP-driven spin-out model,<sup>11</sup> the stranded technology and associated IP is assigned by its corporate owner to a Newco called a TACL (Technology Acquisition, Cultivation, and Licensing company) in exchange for some combination of a minority equity ownership interest in the TACL, an up-front payment, a continuing royalty stream, a convertible note, etc. The originator will typically also get an exclusive field-of-use grant-back license limited to its primary business. This is essential in the multiapplication type of stranded technology, but is also applicable to the noncore variant. The exclusive field-of-use grant-back

may also extend to improvements on the transferred technology developed by the TACL or its licensees. The attractiveness of the exclusive field-of-use grant-back is that for all practical purposes, the IP position of the original technology owner remains essentially the same after the transfer of the IP to the TACL. For example, the originator can still sue and/or license competitors within the field of its primary business. The TACL value proposition to the corporate owner is simple—a partial interest in something of value is better than 100% ownership of nothing.

The TACL typically holds the technology and IP for a period of one to three years during which time the technology is brought to “commercializable” form, and the IP is enhanced through prosecution of pending patent applications, filing of follow-on applications, and possibly acquisition of complementary patents and applications from third parties via patent brokers, auctions, or direct negotiations.

On the financial side, the funding for this technology and IP development comes from capital markets, (e.g., high-net-worth individuals, private equity, hedge funds, etc). In contrast to traditional VC-backed spin-outs, the TACL model is very capital efficient because no investor money is spent on building out operating infrastructure, such as marketing, sales, and human resources departments. The reason is that the return on scaling infrastructure is typically low, zero, or even negative. Instead, all operating capital is focused on the improvement of the technology and IP which, if successful, produces a much higher IRR (internal rate of return) for the investors.

At the end of the holding period, the investor exit takes one of several forms including: M&A (i.e., sale to an operating company for whom the improved technology and IP are core); creation of a stand-alone business by wrapping operating infrastructure around the technology and IP; or in the worst-case scenario where the technology doesn't live up to expectations, sale of the IP to an operating company or a financial buyer. The most interesting exit, however, is the creation of a new kind of licensing entity, in the form of a strategic marketing company that develops and promotes multiple nonoverlapping applications or markets for the technology and IP, and then finds a commercialization partner within each “vertical” that is granted an exclusive field-of-use license.

Regardless of the particular exit chosen, one of the attributes of the TACL model that differentiates it from more traditional spin-outs is that the choice of the monetization model, (i.e., M&A sale, operating

company, licensing company, or IP sale) can be deferred until both the value of the technology and the IP are significantly enhanced.

## CONCLUSION

So far, the various models for extraction of value from intellectual property assets have developed independently of mainstream M&A activity. This adoption lag has resulted principally from traditional investment bankers' perceived inability to accurately value IP assets, and patents in particular, employing the accounting-based metrics used for tangible assets and companies. IP integration efforts are also impeded by a lack of engagement of IP business diligence early in the M&A process, and the absence of trusted comparable IP transaction data to aid decision-making. As better IP valuation models are developed, and as the IP function within a corporation moves up the org chart and is overseen by a CIPD, IP value will become an essential consideration in early stage M&A activity. In parallel with the integration of IP into traditional M&A activity, new forms of IP-driven M&A will emerge and the IP investment banker will play a key role in extracting value from assets in the context of corporate transactions.

### ABOUT THE AUTHOR

**Ron Laurie** has worked in Silicon Valley for over forty-five years, initially as a computer programmer and systems engineer, and then as an Intellectual Property lawyer. In 2004, he cofounded Inflexion Point Strategy, LLC, an Intellectual Property investment bank that advises technology companies and institutional investors in M&A and licensing transactions. Prior to launching Inflexion Point, Mr. Laurie was a founding partner of Skadden Arps' Palo Alto office where he chaired the firm's IP Strategy and Transactions Group for six years. He was also a founding partner of the Silicon Valley offices of Weil, Gotshal, and Irell & Manella.

As a lawyer, Mr. Laurie advised clients in the semiconductor, computer, software, communications, and media and financial services industries on intellectual property strategy—a subject he taught at

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Stanford and Boalt (UC Berkeley) law schools—with a primary focus on the strategic use of IP assets in complex business transactions including mergers and acquisitions, technology divestitures and spin-outs, joint ventures, and strategic alliances. At Skadden, he led IP teams in some of the largest technology deals ever done, worth over \$50 billion. Mr. Laurie is a registered patent attorney and a substantial part of his prior law practice involved strategic planning, competitive analysis, and commercial exploitation of patents. He wrote the Priceline “reverse auction” patent that was the first Internet business method patent to gain national attention when it issued in 1998.

## ■ NOTES

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