The evolving role of intellectual property in M&A transactions

The sea changes underway in the IP market – in particular, those involving patents – are increasingly having an impact on deal making in significant M&A transactions

By Nader A Mousavi

Intellectual property has not always played a central role in M&A deals. IP has long been central to deal making in certain IP-intensive industries, such as in life sciences, where the value of pharmaceuticals can often be viewed as synonymous with the scope of patent protection, and in certain deal structures, such as spin-outs and joint ventures, where the careful allocation of IP rights is an unavoidable necessity. However, in significant M&A deals more broadly, it was not unusual for an acquirer to decide to proceed with a typical acquisition, determine a valuation, negotiate principal deal terms and even finalise the structure of the transaction before involving IP experts, whether internal or external. Intellectual property was the proverbial caboose of the M&A train: happy to tag along for the ride, but certainly not driving the value, direction, structure or other business terms of the deal.

This was particularly true for valuation in M&A deals. Bankers and others involved in valuing a target (including a spin-out) generally would not endeavour to value the intellectual property separately from the target’s business. Conceptually, intellectual property has often been viewed, like machinery used to produce a product, as an asset inextricably bound to the business and revenues of the target. Moreover, intellectual property is notoriously difficult to value. In this context, acquirers and their bankers would view the earnings before interest, taxes, depreciation and amortisation (EBITDA), discounted cash flows or market capitalisation of a target business as capturing the full value of the target’s intellectual property. That is, the intellectual property would already be priced into those business or market measures. In any case, even if an acquirer perceived independent value in the intellectual property of a target, it would not be in the acquirer’s interest to identify that value, for fear of driving up the price it would have to pay for the target as a whole.

Evolving role of IP in M&A

But as the market for and perceived value of intellectual property – particularly patents – has evolved, the M&A deal-making environment is also changing. Three significant IP trends in particular are driving this evolution. First, intellectual property as a percentage of the overall market value of major US and non-US companies has grown dramatically in recent decades. For example, for S&P 500 companies, intangible market value (of which IP value is the majority) as a percentage of total market value has reportedly increased from 17% in 1975 to 32% in 1985, 68% in 1995 and 81% in 2009.

Former Federal Reserve Chairman Alan Greenspan highlighted this trend in a speech in 2004: “In recent decades, the fraction of total output of the US economy that is essentially conceptual rather than physical has been rising. The trend has, of necessity, shifted the emphasis in asset valuation from physical property to intellectual property and to the legal rights inherent in intellectual property.”

Similar — albeit slightly lower — figures apply to companies in China and the European Union. Whether this value resides

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in the brand of a consumer products company, the film library of a movie studio, the customer data of an internet company, the trade secret source code of a software company or the patent portfolio of a technology company, intellectual property is now often the most significant asset of a target in a M&A deal. It is increasingly the heart of what is being acquired and thus, by definition, a driver for the deal.

A second IP trend affecting M&A deals is that the market for buying and selling patents has become more liquid. Non-practising entities (NPEs) and increasing patent litigation have driven companies to adopt new strategies to address patent exposure, while significant patent aggregators such as Intellectual Ventures and RPX have increased the purchasing power on the patent market, and auctioneers, brokers and other professionals such as Ocean Tomo have facilitated those sales. Thus, patents are no longer necessarily viewed as intrinsically tied to the businesses from which they were generated. Rather, both acquirers and targets increasingly view patents as having a value independent from the business of the target.

Third, patent valuation has become increasingly sophisticated. To be sure, IP valuation is still as much art as it is science. However, litigators and damages experts regularly project the licensing value of intellectual property in the context of litigation, and acquirers generally seek to project damages exposure in any actual or threatened IP claim against a target. While the results of these assessments may vary widely, and the law of damages underpinning these valuations is itself changing (particularly in the US), the valuation methodologies are established and robust. Evaluation of the offensive value of IP, particularly patents, has also gained rigour. This activity centres around evaluating the net present value of target IP, particularly patents, and adjusting for the risks and costs associated with assertion.

In these evaluations, IP professionals take into account not only the strength and scope of patent claims, revenues exposure, the practicality of design-around and litigation risks such as invalidity, but also the fact that the value of the patents may vary considerably depending on who owns them. In the hands of an NPE, the values may be limited to a reasonable royalty, while in the hands of the inventing party that participates in the market relevant to the patent, the patent value may be enhanced based on the ability to seek an injunction against the use of the patented invention, or the leverage to obtain freedom to operate through cross-licensing.

IP as a driver of M&A deal value
Given that IP constitutes most of the value of so many companies today, it is no surprise that M&A activity is increasingly driven by IP. Consider these two examples:

- Roche spent nearly US$2 billion to acquire two companies, first IGEN (in 2003) and then a spin-out from IGEN called Bioveris (in 2007), solely to obtain a licence to exploit a technology called ECL that was essential to Roche’s immunoassay diagnostic business. Roche had originally obtained a licence to use ECL from IGEN in 1992, but when Roche strayed outside of its authorised field of use, IGEN asserted breach, and that claim resulted in a jury verdict against Roche of US$468 million. While that verdict was overturned, a US appeals court affirmed the termination of Roche’s ECL rights. In response, Roche acquired IGEN for US$1.25 billion.

IP and M&A – the traditional approach
In the M&A context, intellectual property has often been viewed mostly as a risk factor, akin to assessing potential exposure on environmental or other hazards that only domain experts would endeavour to understand fully.

The fundamental inquiry is to determine whether the target has the intellectual property it needs to operate its business, to identify gaps or exposures and to allocate identified and unidentified risks between acquirer and target, usually through representations and warranties of the target. Such risks may include any actual or potential infringement of third-party intellectual property; loss of any material in-bound licences following the change of control; and the validity or enforceability of material intellectual property.

In the case of a material undisclosed IP risk or liability, the typical remedies for an acquirer would be either to walk away from the deal because a condition of closing had not been met or, in an acquisition of a privately held target, to seek indemnification, subject to pre-negotiated caps and collars, to compensate it for the resulting costs and damages. In a public deal, the acquirer often would not have the right to walk unless the risk or liability had a material adverse effect on the target as a whole, which is generally viewed as a very high threshold.
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There is a significant and developing body of law that is closely followed by M&A practitioners and IP specialists alike on exactly when a M&A deal may result in the loss of critical IP rights.

In a complex M&A deal structure, the net result of which was that IGEN’s only remaining asset that Roche acquired was a non-exclusive licence to use ECL in patient diagnostics. The rest of Roche’s assets were spun out into a company called Bioveris. This complex M&A structure was all intended to resolve Roche’s IP exposure, while also protecting the interests of IGEN’s joint venture partner, Meso Scale Diagnostics (MSD), which had earlier acquired a very broad exclusive licence for ECL. However, it did not work as Roche had hoped. Bioveris soon claimed that Roche was again selling ECL product outside of its authorised field and again Roche responded with an M&A deal. As a result, it acquired Bioveris, the owner of ECL IP, for US$600 million. Was the second time a charm? Perhaps not. The joint venture partner, MSD, has since asserted that the M&A deal violated the anti-assignment clause of the agreement under which MSD had consented to the original creation of Bioveris. This saga continues unresolved today, as colourfully illustrated by a recent Delaware court decision (Meso Scale v Roche) suggesting that MSD’s claims may have life. If MSD were ultimately to prevail, would Roche consider also acquiring MSD? Time will tell. In any case, this story certainly shows that where IP becomes essential to significant businesses, and particularly where those rights are threatened, IP can drive complex and high-value M&A activity.

Another example of IP driving significant M&A activity is the story of InterTrust Technologies. InterTrust was founded in 1990 and developed a strong business in digital rights management (DRM) and was listed on NASDAQ. After early success, its business faltered, but it had in the meantime established a powerful patent portfolio in DRM. InterTrust was put up for sale as a pure IP holding company; it had no customers, no revenues and no assets, other than patents and a patent infringement suit against Microsoft. It was then acquired for US$453 million by Fidelio, a joint venture of Sony, Philips and others. This is an example not only of pure IP-driven M&A, but also of how the residual value of patents can exceed the value of the business from which those patents were generated, and alone salvage a return for its investors through an M&A exit.

IP as a driver for M&A deal structures

Savvy M&A practitioners now regularly take key IP issues into account when structuring their deals. This is particularly the case where a target relies on a critical IP in-licence that is non-assignable or subject to termination upon a change of control. For example, the licensed intellectual property may be material to the target’s products and not readily substitutable or practical to design around. In such cases deal structures that would be likely to constitute an assignment under applicable law, and therefore potentially breach that in-licence, would be unfavourable. These might include an asset transfer or a forward merger where the target entity ceased to exist. On the other hand, deal structures that did not in themselves constitute an assignment and therefore would not breach the anti-assignment provision of the critical in-licence would be favoured. These might include a share acquisition or a reverse merger, where the target entity survived, although the recent Delaware case noted (Meso Scale v Roche)
## IP risk that is fundamental to the deal value

Where intellectual property is fundamental to the deal value, it is no longer adequate to view intellectual property merely as a matter of risk allocation. Cautionary tales abound of M&A deals where an acquirer overlooked or miscalculated a significant IP issue only to undermine the essence of the deal, even in industries that would not on their face appear to be IP-intensive. Consider the following two examples:

- Volkswagen acquired the Rolls-Royce Motor Cars business from conglomerate Vickers PLC for US$790 million, but the deal left out one critical asset: the Rolls-Royce brand. That trademark was controlled by British jet engine maker Rolls-Royce PLC, which instead transferred the Rolls-Royce Motor Cars brand to BMW for US$66 million. Volkswagen owned the Rolls-Royce car business and could make and sell the same Rolls-Royce cars from the same storied manufacturing facility as Rolls-Royce Motor Cars had done, but it could not use the name. Volkswagen reached a settlement with BMW enabling Volkswagen to use the Bentley name, but Volkswagen lost perhaps the most valuable asset of the business: the brand recognition and goodwill associated with the Rolls-Royce name. It was a significant embarrassment for Volkswagen, a coup for BMW and a lesson for M&A professionals.
- Acquisitions of software-intensive businesses have been transformed by the rise of open source software, with attendant new opportunities and risks. A well-publicised example is Cisco’s US$500 million acquisition of Linksys, a maker of consumer routers. Cisco, a highly sophisticated acquirer, apparently did not realise at the time of the acquisition that Linksys had a serious open source problem. Linksys had incorporated software licensed under the General Public Licence (GPL) into its networking devices which it distributed to consumers, without disclosing that code in source code form, as required by the GPL. The Free Software Foundation (FSF) sued Cisco, insisting that it make the source code in a key Linksys product line publicly available under the GPL. After several years of dispute, the case finally settled. Cisco agreed to FSF’s demand to publicly disclose arguably a crown jewel asset of Linksys – its source code – under the GPL, allowing anyone, even direct competitors, to exploit it freely. Even so, Cisco avoided an even more damaging potential outcome: had it merged the GPL code into other proprietary code – for example, in its router product lines – it may have been forced to publicly disclose a crown jewel of the entire Cisco franchise. Such cautionary tales bear out that where significant value is attributed to proprietary software of a target, it is best practice for sophisticated acquirers to run code scans as part of pre-acquisition due diligence to identify all open source code and third-party code and address issues and allocate risk before consummating an acquisition.

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<tr>
<th>Year</th>
<th>Deal Description</th>
<th>Acquirer</th>
<th>Target</th>
<th>Outcome</th>
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<td>2010</td>
<td>AMD, an investment arm of the Emirate of Abu Dhabi, acquired an IP licence from Intel to make x86 chips. The joint venture, called Globalfoundries, would remain a subsidiary of AMD and would therefore continue to enjoy the benefits of IP in-licences of AMD. The case illustrated the importance of disclosing IP in-licences of the parent/seller.</td>
<td>AMD</td>
<td>Globalfoundries</td>
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<td>2008</td>
<td>Nokia Siemens Networks (NSN) acquired an IP licence from Intel to make x86 chips. The joint venture, called Globalfoundries, would remain a subsidiary of AMD and would therefore continue to enjoy the benefits of IP in-licences of AMD. The case illustrated the importance of disclosing IP in-licences of the parent/seller.</td>
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acquirer, the common position is that all IP of a target, including its patents, is already included in the valuation of the target business as a whole. This may be an acceptable result in cases where the IP fundamentally relates only to the products of the target business.

However, where there are significant applications of the target’s IP outside the field of its business, a target and its shareholders may be leaving money on the table if that IP is not separately valued, since most M&A valuation methods (eg, discounted cash flow, EBITDA multiple) are unlikely to account for value unrelated to the target business. Worse still, the acquirer may have no interest in exploiting the target’s IP in those unrelated fields.

Under these circumstances, some targets are calling the bluff of acquirers and, prior to or in connection with an acquisition, are actually selling IP, particularly patents, with significant applications outside of their business, and taking typically an exclusive grant-back licence in the relevant field for their business. This may make sense for any target that reaps a higher return from separating its assets in this way. Acquirers such as Intellectual Ventures have reportedly done similar deals. In a well-publicised example, the founders of Skype reserved certain IP rights when initially acquired by eBay in 2005, and subsequently sold that IP to Skype as part of a settlement, ultimately clearing the way for Skype’s US$8.5 billion pending sale to Microsoft. Of course, an acquirer may object to any reservation or exclusion of IP rights in a target on a number of grounds, including the following:

- It strips out expected value.
- A field licence may constrain the target’s business from growth or integration into the acquirer’s business.
- The target may have lost control of the prosecution and enforcement of such patents.
- As a licensee, the target could be exposed to losing the licence upon a future claim of breach or bankruptcy of the licensor.

Similar issues arise in spin-out transactions, where a seller is necessarily allocating intellectual property and other assets between the target’s spin-out business and the seller’s retained businesses. In such cases significant negotiations are common over which patents should go with the target spin-out. A typical exercise would be to identify those patents that are exclusively related to the target spin-out business and ensure that, at minimum, at least those patents will be divested with the spin-out. However, sellers are increasingly seeking to divest businesses – even significant businesses – with fewer patents, so that they can retain maximum patent leverage for their retained businesses.

Maximising the value of target IP for an acquirer

Even acquirers are considering whether they would prefer to spin off patents of a target before or simultaneously with the acquisition of that target. This is particularly the case for acquirers with significant cross-licensing arrangements that would capture the target’s patents the moment that the target became controlled by the acquirer. The value of those patents may be higher, both to the acquirer and to any potential purchaser of those patents, if the target’s patents remain unencumbered by the acquirer’s cross-licences. Of course,
the acquirer will want to ensure that it receives a broad, irrevocable and royalty-free licence-back under those patents prior to divesting them.

**Leveraging IP to finance M&A activity**

Intellectual property has been used as a vehicle for financing M&A activity or taking out debt incurred in connection with an acquisition. The type of financing may take different forms.

First, there are private sales or consortium acquisitions, where the proceeds are used directly to finance the acquisition. For example, in the recently announced acquisition of Novell by Attachmate, Microsoft led a consortium that acquired more than 800 patents from Novell for a significant value.

Second, although less common, there are securitisations of intellectual property. For example, in 2006 three private equity firms acquired Dunkin’ Brands with debt and then, in a widely reported deal, paid off that debt by raising US$1.7 billion by selling bonds backed by, among other things, the trademark royalties it would receive from its franchisees. While securitisising intellectual property has remained a niche market, there are numerous examples of securitisations of copyrights (eg, Dreamworks, Bowie Bonds), trademarks (eg, Dunkin’, Guess?) and patents (eg, Yale’s rights in BMS royalties on Zerit), amounting to in excess of US$10 billion of proceeds since the market was established in 1997.

**IP litigation as a strategic tool in M&A**

IP litigation has long been used as a tool for companies to achieve strategic goals, such as leverage over competitors. Increasingly, it appears that these strategic goals are overlapping with M&A activity. Partly, this is a matter of timing. Patent and other aggrieved IP plaintiffs often strike a target once a potential acquisition deal has been announced, as this is a point of significant leverage due to the risk that litigation may interfere with an M&A liquidity event for the target. Although unfortunate when used merely as a tactic, where credible, this approach may provide additional hold-up value to the IP plaintiff.

Also, companies engaged in IP litigation sometimes discuss M&A, and conversely failed M&A discussions can lead to IP litigation. The result can be an interesting and complex dance between M&A courtship and IP disputes, where IP infringement actions may provide additional leverage in bids to acquire potential targets and, as in the Roche/IGEN case cited above, acquisitions may afford a means to snuff out exposure to IP litigation. For example:

- In 2006 IBM initiated a patent infringement suit against Platform Solutions. In 2007 Platform Solutions countersued on patent and unfair competition grounds. In 2008 IBM acquired Platform Solutions and naturally ended the legal claims.
- Broadcom made a series of widely publicised friendly, then hostile bids to acquire Emulex, which were rebuffed by the Emulex board. Subsequently, Broadcom sued Emulex for patent infringement of 10 patents and Emulex countersued.
- Chinese network equipment maker Huawei won a preliminary injunction from a US court preventing Motorola Solutions from carrying out the transfer of trade secrets to NSN, which had threatened to complicate a US$1.2 billion deal through which NSN would acquire Motorola’s telecommunication equipment network business. This suit was recently settled.

**The IP poison pill**

Intellectual property has also been used as a basis for a so-called poison pill to defend against hostile bids in high-stakes public M&A deals. In 2004 Sanofi made an all-stock hostile takeover bid for Aventis valued at €46 billion, which was a significant premium over the then-current price of Aventis shares. However, the consideration in the transaction was Sanofi stock. Aventis management believed that there was a significant downside risk to the Sanofi stock if Sanofi were to lose a highly material pending US patent litigation over its key product, a blood-thinning drug called Plavix. Accordingly, Aventis instituted a takeover defence that was structured in the form of warrants issued to the Aventis shareholders that were not transferable to Sanofi and would continue to exist after any acquisition of Aventis. These warrants would compensate the Aventis shareholders for the loss in value of the Sanofi stock they had received were Sanofi to lose the pending litigation by shifting significant value from historic Sanofi shareholders to ex-Aventis shareholders.

Although the takeover defence was ultimately held to be unenforceable under French takeover law, it was probably relevant to Sanofi’s decision to raise its price. In other contexts, companies have considered creating a poison pill in the form of a requirement to sell the target’s intellectual
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Action plan

IP issues and appropriate diligence in M&A deals vary widely from industry to industry and deal to deal. However, common steps for acquirers in assessing IP issues in a potential acquisition include the following:

- Put together a due diligence request list that is comprehensive and concise, and relevant to the specific business of the target.
- Identify and interview key personnel who are most knowledgeable about IP and technology issues, including the general counsel, chief IP officer, chief technology officer, chief information officer, vice president of engineering and outside IP counsel.
- Identify the intellectual property of the target – both owned and in-licensed – which is material to its business.
- Trace the provenance of material intellectual property from its development or acquisition by the target.
- Analyse in-licences to determine assignment/change of control issues and whether terms are adequate to support ongoing business.
- Analyse out-licences to ensure that there are no exclusive rights which would preclude anticipated activities of the target or acquirer; no licences bind the acquirer or its other subsidiaries; out-licences are all granted in the ordinary course of business; and no material indemnity obligations are owed to customers or other third parties.
- Assess material IP litigation and, in particular, the worst-case and likely case exposure in each material IP litigation.
- In an acquisition of a proprietary software company, consider using a source code scanning vendor (eg, Palamida or Black Duck) to identify open source and third-party components in the source code.

Evolution role

The value of intellectual property as a proportion of the market value of targets continues to grow. As intellectual property – particularly patents – is increasingly viewed as an asset with distinct and separable value from the businesses of targets, we are likely to continue to see the role of intellectual property evolve and gain relevance in driving, facilitating and financing M&A transactions for the benefit of both targets and acquirers.

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The opinions expressed in this article are solely those of the author.

As a matter of disclosure, the author advised a party in the following transactions cited above: Intel/AMD, Microsoft/Novell, Silverlake/Skype and Skype/Microsoft