Licensing Due Diligence

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Much is written about the need for proper due diligence during the course of mergers, acquisitions, and other large corporate transactions. Often overlooked is the need for appropriate due diligence in the context of significant licensing activity. Whether representing the prospective licensor or licensee, an appropriate amount of diligence is an invaluable tool for preparing a portfolio for licensing, or determining the price that should be set for the license.

Due diligence of intellectual property related due diligence is first to determine what intellectual property exists. Second in this natural progression is determining who owns the relevant intellectual property. The third step is to associate the various intellectual property assets with the lines of business and prospective areas of business growth. The next step in the process usually involves determining if there are any warts on the intellectual property portfolio. Finally, one seeks to understand the competitive marketplace, and determine if any third-party intellectual property rights may affect the portfolio.

From the perspective of the prospective licensor, the goal is simple – identify problems before taking the IP estate to market, and correct them, if possible. If it is not possible to correct the problems, then early self-diligence will allow the prospective licensor to develop a position on the issue, and be prepared to meet objections during the course of negotiations. From the perspective of the prospective licensee, the goals are equally straightforward – do I need the license, if I do, and can the licensor provide me with a portfolio that I can use?

While simply stated, in practice, each of these issues faced during a licensing due diligence is oftentimes extraordinarily complex.

Before diving into due diligence in the context of licensing activity, it is critical to budget for the exercise. Without proper fiscal management, the diligence exercise can, in short order, consume the value of the transaction. The extent of the diligence should be driven, in large part, by the perceived value of the deal. That said, one fact of such diligence is to expect the unexpected, and plan for “task creep,” the phenomenon by which the scope of the original project changes and expands over time. Anticipating this issue, the diligence team should plan to revisit the budget, and the scope of the work, periodically during the course of the project.

From the perspective of the prospective licensor, the purpose of early diligence is to prepare the portfolio for out-licensing. There are a number of critical steps here. Principally, the diligence team needs to gain an understanding of the extent of the estate at issue. This is best done by looking at the portfolio from the perspective of a prospective licensee. Issues here include technical ones, such as ownership, payment of maintenance fees, and the like. The last place to learn that one does not own what they are purporting to license, or that a key patent has lapsed for failure to pay a maintenance fee, is across the negotiating table. For example, in one recent instance, we had succeeded to take over management of a portfolio from another firm. In preparing the portfolio to go to market, our diligence determined that one of the key patents had been allowed to lapse by prior counsel, and that the time to revive the patent was nearing an end. We were able to have the patent reinstated, and did not have to face the embarrassment of asserting a lapsed patent.

It is also a valuable exercise at this time to review the patent for holes in the portfolio, and to assess design around options. Any savvy licensee, when presented with an offer to license, will immediately seek to determine if they need the portfolio, or if there are any holes or potential design around options. If these are discovered during the initial diligence, it may be possible to file continuing applications in order to expand the portfolio, or even acquire other patents that may cut off design around options. This is also an excellent opportunity for an extensive brainstorming session. If cost-justified, the commencement of serious licensing activity is a way to bring together the members of research and development, marketing, and other departments and peer into the future. In a number of cases, we have used such sessions to generate significant patentable inventions. Even if the company does not intend to practice the resulting intellectual property, any issuing patents provide a significant hedge against competition, and potential increased opportunities for licensees.

Additionally, this is an opportunity to find mistakes in the portfolio before the other party is in a position to capitalize on them. Again, by way of example, in one recent engagement a pre-licensing portfolio review revealed that there was an error in certain of the claims of one of the patents. In this case, we were able to cure the issue through a certificate of correction. This would have been much more difficult to accomplish, and may have severely compromised the negotiations, if the error was discovered after the opening of licensing talks. In simple terms, by the end of this process, the diligence team should understand the limits of the portfolio, and have addressed them.

Turning to look at the issue from the perspective of the prospective licensee, the initial assessment will be of the scope and strength of the patents that are on the table. Keep in mind that while broad claims increase patent scope, they can also make the patents vulnerable to prior art challenges. Similarly, when assessing the appropriateness of taking a license under a particular patent or portfolio, the prospective licensee will look to determine if the patents cover their current or anticipated commercial technology, as well as reasonably anticipated future developments. Similarly, a prospective licensee will usually also be interested in determining if the patents cover competitors’ projected developments, as well as other areas where the market may be headed. Lastly, the prospective licensee will assess fundamental issues such as whether or not the portfolio is likely to withstand attack.

In assessing the portfolio, the prospective licensee will also focus on the ability to utilize the technology that is the subject of the license. Keeping in mind that a license is not a right to use, but rather a right to exclude, taking a license does not carry with it the right to practice the subject of the patent. As a result, proper diligence must include an assessment of any potential blocking patents, and a full right-to-use study. In the first instance, the question is whether the potential blocking patent can be designed around. If not, the second issue is whether there is also a need to take a license under the blocking patent. (In many instances it will make sense for the licensor to acquire this patent, or the right to grant sublicenses under this patent, before entering into license negotiations.) Lastly, one may need to determine if the potential blocking patent is valid.

Proper in-license due diligence also requires understanding the technology and proposed applications in a manner sufficient to determine if everything necessary to practice the licensed estate is transferred. Examples of necessary add-ons to the license include training, assistance in implementation, cell lines, access to suppliers and vendors, source code, material transfer agreements, and similar materials. Remember, the licensor may not be obligated to provide such information and materials unless the same is explicitly provided for in the agreement.

At the end of the process, the purpose of diligence is to assist the parties in striking the fair and proper commercial terms – ones that allocate the risks and burdens, and provide a fair return to each side. In some instances, the diligence will result in adjusting the terms of the agreement, including the royalty. In other situations, the diligence may reveal information that precludes doing the deal altogether. For either side, the diligence team should deliver a report that identifies all open issues, and details all required follow-up. In addition, the report should contain on the accuracy of all disclosures made to date, and highlight any inaccuracies. The diligence teams should also be creative in proposing solutions. Issues such as representations and warranties may address some issues. In other situations, indemnities and other provisions may be warranted. Lastly, a creative licensing structure, i.e. one that stacks or tiers royalties in the face of potential third party patents, may help overcome obstacles.

BEST PRACTICES:

- **Licensor**
  - Review portfolio as if prospective licensee
  - Fix problems before they affect deal value

- **Licensee**
  - Examine portfolio as if acquiring
  - Make sure you receive everything you need to practice
  - Look for alternatives to drive down cost

Where data is available from two-sources, double check

Make sure diligence team understands technology

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Please email the author at ilevy@goodwinprocter.com with questions about this article.