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A Buyers' Market: Unprecedented Opportunities in Intellectual Property Acquisitions

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The crisis in global financial markets is creating unprecedented opportunities for buyers of intellectual property. Sophisticated buyers are taking advantage of these opportunities to bolster their intellectual property portfolios, as well as to add new products and technologies to their companies. This article discusses the origin of these opportunities, and shows why conditions giving rise to them are forecasted to persist. To assist readers in understanding the unique market for intellectual property and technology, we offer an analysis of the different processes companies employ in selling these assets, and a discussion of critical success factors for buyers.

The term technology company is used throughout this article to refer broadly to high technology, life science, and clean technology companies.

Startup Companies Are a Source of High Quality Intellectual Property

Historically, much of the innovation in the technology and intellectual property markets has originated from startup companies. Although in sheer volume, large companies file (as a class) and are issued a greater number of patents than startup companies,

patents issued to startup companies tend to be broader and more fundamental in their respective market than patents issued to large companies. Patents held by startup companies typically also enjoy advantageous priority dates.

The attractiveness of intellectual property originating in startup companies is due to two factors. First, and by definition, startup companies innovate in nascent fields. They therefore enjoy a first-mover advantage, and are able to build broad "Greenfield" intellectual property portfolios, unconstrained by prior intellectual property. Second, the limited financial resources of startup companies serve to sharpen the focus on important intellectual property. Although large companies may see value in having a large volume of patents, and consequently may file patents even on relatively minor innovation, severe budget constraints that typically exist in startup companies force those companies to adopt an intellectual property strategy that files for intellectual property protection only on fundamental and strong innovations, relegating the protection of more minor innovations through non-patent means such as trade secrets.

Current Market Conditions Are Adversely Affecting Startup Companies

While the market downturn of 2001 to 2003 predominantly affected technology companies, the economic crisis of the last year and a half has had a broad effect spanning almost all industries. Several unique factors are combining to make the current economic environment particularly difficult for startup companies. Before discussing those factors, it is helpful to become familiar with the typical evolution of a startup company. Startup companies typically progress through four phases of development:

1. A *startup phase* in which the company develops its initial product or service offering and tests prototypes and prospective markets;

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2. An *early development phase* in which the company commercializes its prototypes into fully fledged products or services;
 3. An *expansion phase* in which the company commences sales, and progresses from early sales through sizeable sales; and
 4. The *bridge/IPO phase* in which the company continues to scale its operations and revenues in anticipation of an impending Initial Public Offering (IPO) or other event giving liquidity to the company's investors.

Startup companies typically do not reach profitability until well into the expansion phase (and, in many cases, not until they enter the bridge/IPO phase), which is usually three to five years following the business commencement date. To fund their operations prior to reaching profitability, startup companies turn predominantly to venture capital financing sources. By selling preferred equity securities and other rights in the business to Venture Capitalists (VCs), a startup company is able to raise the capital it needs until reaching liquidity. Venture capital is a very expensive form of financing because, commensurate with the high risk they are undertaking, VCs demand high rates of returns—typically over 40 percent or even 50 percent per annum.

Because the cost of equity for the startup company declines as the company matures, and because VCs prefer to manage their risk by allocating capital based on indication of progress, startups very rarely raise enough capital in their startup phase to last all the way to an IPO. Instead, capital is raised in rounds. For example, a startup company may raise seed financing in conjunction with commencing operations, raise a “Series A” round as it enters the development phase, raise “Series B” and “Series C” rounds as it progresses through the expansion phase, and raise a “Series D” mezzanine round within six months of the IPO during the bridge/IPO phase. This staged financing strategy means that startup companies need to continuously justify their investment thesis. It also means that startup companies may find themselves in need of capital during inopportune times.

The current economic crisis is making fund raising for many startup companies extremely difficult. This is for two reasons: (1) scarcity of capital and (2) core business weakness concerns. Look at the capital markets first. Recall that at any given time, investors in technology companies require that the startup possess the potential for very high returns on investment. The typical mechanism providing liquidity to venture investors, an Initial Public Offering (IPO) of shares in the portfolio company, has been essentially shut down for the last year and a half. Furthermore,

it is clear to VCs, investment bankers, and executives that the IPO market will not re-open any time in 2009 and, possibly not even in 2010. The second traditional engine for large returns on investments in technology startup companies, sizeable Mergers and Acquisitions (M&As), also has become rare. With liquidity events postponed, VCs need to reserve more capital resources for their own portfolio companies. That creates scarcity in the capital markets. As an example, according to the National Venture Capital Association (NVCA), a trade group for the VC industry, during 2008, venture capital investments in startup companies dropped from \$7.86 billion, \$7.69 billion, and \$7.34 billion in the first, second, and third quarters, respectively, to \$5.40 billion in the fourth quarter of 2008 and \$3.9 billion in the first quarter of 2009—a drop of almost 50 percent.

The second reason startup companies are finding it difficult to raise funding in the current environment is because weakness in the economy is making it more difficult for these companies to meet revenue, growth, and profitability milestones. In times of economic uncertainty, buyers become concerned with the financial stability of their suppliers. Of course, no one wants to acquire a leading edge product, just to find themselves a few months later deprived of support and warrantee coverage due to the seller going out of business. Conservatism on the part of a startup company's customers can create a vicious cycle, as delays in customer orders worsens the financial standing of the startup company which, in turn, makes it more difficult for the startup company to raise additional funding or obtain additional sales orders.

The result is a compression of value among startup companies. According to research firm 451 Group, in January 2009, the average transaction price for sales of private, US-based VC-backed companies was \$5.7 million. This is sharply down from average transaction prices of \$44.2 million seen in January 2008, and represents a significant opportunity for acquirers of startup companies or their intellectual property.

Established Companies also Are Sources for Intellectual Property Opportunities

The economic crisis also is affecting established companies. Established companies are facing declining revenues and a difficult financing environment. Private sources of financing, such as bank loans and credit lines, are hard to obtain. At the same time, declining share prices in the public markets make

issuance of additional equity expensive or impossible. The result is continued strain on businesses. According to the American Bankruptcy Institute, 43,546 businesses filed for bankruptcy in the United States in 2008. Annual corporate bankruptcy filings in the United States increased 44 percent from 2006 to 2007 and 54 percent from 2007 to 2008. In these times, established companies are looking to monetize intellectual property through sales and licenses as such transactions represent smart use of resources and can generate cash for the corporation with relatively little additional investment.

How Intellectual Property Is Being Transacted in Today's Markets

In general, the methods by which companies sell their intellectual property fall into two categories: (1) sales from operating companies and (2) sales from reorganization or liquidation processes.

Sales from Operating Companies

In operating company sales, a company may sell intellectual property that it no longer needs or license intellectual property for fields of use it is not pursuing. The buyer will acquire the intellectual property, or rights to the intellectual property, in a transaction drawn directly between it and the selling company. Because the seller is in good business standing, detailed due diligence will predate the transaction, and customary representations and warranties will accompany the sale. The buyer also can expect good post-transaction support, for example with technology transfer for utilizing the acquired intellectual property, with access to inventors for information on past and follow-on inventions, etc.

Workout Sales

Sales from liquidation or reorganization processes take many forms, and depend on the condition of the seller and the reorganization or liquidation process used. A company facing financial strain will first attempt to negotiate directly with its creditors for forbearance or other form of debt restructuring or forgiveness. Some lenders will require, as a condition of such concessions, that the company shed a business line or other assets, giving rise to intellectual property acquisition opportunities.

In a workout sale, the seller will be dealing directly with the selling company. However, the time allowed for due diligence may be limited, necessitating a

quick sale (with a corresponding attractive value for the buyer). Likewise, and as a practical matter, the value of any seller warranties will be limited, given the financial state of the seller. An issue of particular importance in workout sales relates to good title. Buyers are well advised to check title for any encumbrances by creditors (particularly by secured creditors), confirm that the seller has reached settlement with all major creditors, or, in the alternate, obtain specific waivers from creditors in support of the sale. In startup companies, it is very common for venture debt or bridge financings to include blanket liens covering the company's hard and soft assets. Therefore, if the company has been funded recently by capital infusions from existing equity holders, there is likely to be a lien against the assets of the company.

Chapter 11 Reorganizations

In more complex circumstances, a company may not be able to use an informal process to restructure its debt, and will instead file for Chapter 11 bankruptcy. A Chapter 11 bankruptcy gives the company and its creditors a structured environment in which to work to reorganize the company. Traditionally, the sale of a business or significant property in Chapter 11 was accomplished through transactions taken in conjunction with, or following, the confirmation of the debtor's plan of reorganization. A plan of reorganization is a very detailed document that describes how the debtor will be reorganized, and deals with the effect of reorganization on each class of creditors and equity holders. Because bankruptcy law requires that the plan be put to a vote and accepted by a majority of the affected parties, the plan confirmation process can take many months. Sales that are part of a debtors' reorganization can take a very long time, causing a lot of uncertainty for the buyer. To generate much needed cash, companies in Chapter 11 bankruptcy (also called "debtor in possession") may sell business units, assets, and intellectual property. The "363 sale," so called after Section 363 of the US Bankruptcy Code, is a common way for companies to conduct such sales while in bankruptcy proceedings, and outside of the debtor's reorganization plan. Fortunately, 363 sales, which can be completed in as little as 60 to 90 days, now are widely recognized by courts as necessary tools for selling key property in order to generate cash for the business. They are a common way for debtors to sell intellectual property, technology, and other assets whose value does not preserve well under financial distress.

A 363 sale typically starts with an initial bidder, also called a stalking horse, who submits an offer for

the acquisition of the debtor's business or intellectual property. The offer is accompanied by a draft asset purchase agreement (APA) detailing the conditions of the sale. With offer in hand, the debtor submits bidding procedures for the bankruptcy court's approval. The resulting court order sets up rules for the continuation of the sale process: how bidders are qualified; the time qualified bidders have to submit "higher and better" bids topping the stalking horse's offer; breakup fees to compensate the stalking horse for its investment of time and effort; and other customary provisions such as the minimum amount by which a bid must exceed the stalking horse bid, the amount and term of deposit that must accompany a bid, and any modifications the buyer is requesting to the stalking horse APA. The debtor then sends a notice of the sale process, waits for the bids to arrive, and holds an auction or auction-like process to determine the best and highest bid. Typically, a sale transaction can consummate within six to eight weeks of the stalking horse's initial bid.

Sales out of a bankruptcy process convey high quality of title. The buyer will be furnished with an order, signed by a bankruptcy judge, attesting to their ownership of the assets free and clear of any liabilities (save for the liabilities the buyer specifically assumes in the APA).

Acquiring intellectual property out of a company in Chapter 11 requires careful analysis. One benefit of a reorganization process is that it allows the debtor (and, indirectly, the buyer) to assume certain obligations and reject others. This allows for flexibility in allowing the buyer to acquire assets and assume contracts that are beneficial to them, while rejecting contracts that are not beneficial. Still, buyers (and debtors) cannot use the bankruptcy process to deprive a licensor of the company's intellectual property of rights they previously obtained, so long as the licensor is in conformance with the terms of the license. Any previous licenses therefore follow the intellectual property.

In the hands of a sophisticated user, 363 sales can allow a buyer to take advantage of the financial distress of the seller, and the power of bankruptcy court, to affect an attractive transaction.

Self Liquidation

In situations where it is impossible to reorganize the company, liquidation is called for. While liquidations can range in formality from informal to very formal, the objective of the process is always the same: sell the assets of the debtor for the maximum amount possible under the circumstances and distribute the proceeds to stakeholders in the company according to

their priorities as established by law. Secured creditors are paid first, followed by unsecured creditors, followed by equity holders. The most informal liquidation process is self-liquidation, where a small number of employees remain and sell the assets of the business one by one or in bulk. A buyer of intellectual property will then be dealing directly with the skeletal team. Similar to workout sales, good title, unencumbered by creditors, is key to a successful technology or intellectual property acquisition. The sale likely is to be "where-is as-is" and, naturally, warranties given by the company will carry, as a practical matter, far less weight than in a sale out of a going concern. This necessitates good due diligence on the part of the buyer.

Assignment for the Benefit of Creditors

Next in the order of formality among liquidation processes is a general assignment. In a General Assignment for the Benefit of Creditors (ABC), the insolvent company transfers legal title, as well as custody and control of its property, to a third party (the assignee) in trust. The assignee sells the property, and applies the proceeds to the debtor's creditors according to their priorities. The assignee typically has considerable leeway in the way he or she chooses to sell the company's property, and a buyer of intellectual property typically will deal with the assignee, or with an agent of the assignee retained specifically to assist in the sale of the intellectual property, directly. In many states, the ABC process is a relatively well-established common law process that is an alternative to bankruptcy. Creditors like the assignment process because it is fast and efficient and, for secured creditors, it avoids the need to foreclose and sell collateral. Buyers like the ABC process because it allows for a relatively quick sale, and gives almost as good title protection as a bankruptcy. As in other liquidation sales, the transaction will be for the assets "where-is as-is," with no or very few representations or warranties. ABCs are conducted according to state law, and are more popular in certain states than others. Fortunately, both California and Massachusetts, states with large concentrations of technology and life science companies, have much experience with ABCs.

Chapter 7 Bankruptcy Liquidation

The most formal of liquidation processes is a Chapter 7 bankruptcy. Once commenced, the court will assign a trustee to the case. The trustee will be entrusted with selling the debtor's property, and distributing the proceeds to creditors. A Chapter 7

bankruptcy trustee must act according to specific procedures, and typically has far less leeway than an ABC assignee. He or she typically will seek court approval, and use an auction-like process when selling intellectual property. The eventual sale transactions also will need to be approved by the bankruptcy court, giving the buyer high-quality title to the acquired assets. Intellectual property buyers typically will deal directly with the trustee, or with an agent of the trustee. Another key difference between the ABC process and the Chapter 7 bankruptcy process is that while a debtor and its creditors often choose to retain a specific assignee that they believe is qualified to work on technology cases, Chapter 7 trustees are assigned by the court, usually using some sort of random or round-robin process. Given the generalist nature of trustees, an assigned Chapter 7 trustee may not have as good an understanding of how to deal with intellectual property. This can make a potential buyer's due diligence of the intellectual property challenging.

Foreclosure Sales

Providers of debt to technology companies frequently hold a lien against the company's assets—tangible and intangible. Such blanket liens are common in connection with venture debt—a type of high-risk non-traditional lending available to startup and growth companies lacking positive cash flow and significant assets. Venture lenders essentially piggy-back on the due diligence that reputable venture capital firms conduct on the company, placing faith in the company's ability to raise future equity to repay the debt. Historically, it had been rare for venture lenders to foreclose on their security or act independently of the company's VC investors. However, with the slowdown in VC funding for startup companies, the interests of VCs and venture lenders can diverge. Consequently, today's market is seeing more lenders foreclosing on intellectual property (and, in the process, causing the company/debtor to cease operation).

Foreclosure sales represent unique opportunities for buyers of intellectual property. Because the amount owed to the venture lender is typically far less than the amount of equity invested in the startup company (usually by a ratio of about one to ten), a foreclosing lender, while aiming to maximize recovery to all constituents, in practicality is likely to be much less sensitive to price than an equity investor. This is especially true when a lender has to weigh a "quick sale" to a sophisticated buyer against having to invest additional monies to maintain and market the intellectual property for the potential of a better

deal. Of course, the opportunity may come at a price to the buyer of intellectual property, as due diligence may be limited, especially if the foreclosure left some company employees disgruntled.

Five Rules for Successful Acquisitions

Distressed acquisitions, when conducted correctly, can prove to be of tremendous value to buyers of technology and intellectual property. Below are five rules for increasing success in such transactions:

1. *Get to the deal early.* Distressed acquisition processes, whether formal or informal, convey significant benefits on early birds. First, initial and staking horse bidders almost always have more time to conduct due diligence than subsequent bidders. Second, initial bidders have an opportunity to negotiate an asset purchase agreement of their liking, and which subsequent bidders may have difficulty re-negotiating. In addition, early bidders can affect the design of the sales process to their own advantage (*e.g.*, by giving the company limited time to show the deal to other parties). Third, in formal processes such as 363 sales in Chapter 11 bankruptcies, initial bidders ask and often receive breakup fees and cost reimbursements. Early birds also can close deals at very attractive valuations in foreclosure and other sales that may be advertised very lightly or not at all. Successful buyers and their advisors use their extensive networks to stay apprised of acquisition opportunities before these become public.
2. *Be Prepared.* Successful transactions are more the result of good preparation than of pure chance. Anticipating the limited time afforded to due diligence in distressed acquisition, successful buyers do their homework prior to engaging the seller. Fortunately, when acquiring intellectual property, much can be gained from information in the public domain. For example, a prospective buyer can research prosecution histories and title and assignments chains with the help of information from the Patent and Trademark Office. Likewise, the prospective buyer can research security interests and encumbrances using public databases of Uniform Commercial Code Financing Statements. In many cases, a prospective buyer can (and should) reach a tentative value for the technology and intellectual property after researching the seller's patent filings as well as the market. Even in cases for which an exact value cannot be computed, the buyer is well advised to arrive at a range of values. Such a valuation will

later serve to drive the negotiations between the buyer and seller.

3. *Conduct Efficient and Realistic Due Diligence.* As previously discussed, distressed sellers may have limited ability to support buyers' due diligence requests. For example, sales by Chapter 7 trustees are notorious in their lack of access to detailed due diligence materials. Successful buyers identify critical areas for due diligence and focus on those areas. Successful buyers then adjust for gaps in additional due diligence in the price and terms offered for the asset. In any case, several due diligence topics should never be skipped:

- Confirmation of sellers' good rights and title in the property
- Review of patent files and dealing with the Patent and Trademark Office, including the status of filing and maintenance fees
- Review of all relevant license agreements, to understand how the intellectual property is encumbered

Of course, the level of due diligence required will depend on the purpose for which the buyer is acquiring the technology or intellectual property. The more critical the acquired asset is to the buyer's present or future business, the more due diligence is required.

4. *Understand the Selling Process.* Selling processes, especially from distressed companies, have unique characteristics. Understanding the seller's needs and the process employed is important for a successful acquisition. For example, buyers participating in 363 sales or auctions from Chapter 7 liquidations are sometime surprised when auction rules seem to be tossed out the window at the last moment, just to allow the seller to accommodate an additional party in a bid to extract additional value. Bankruptcy courts often will allow such escape hatches if they are deemed to benefit the debtor and its creditors. Parties, or with their advisors, should have experience with these processes and related idiosyncrasies, as well as how to work those to the advantage of the buyer.

5. *Be Realistic in Deal Terms Offered and Requested.* Speed and momentum are key contributors to successful transactions. By understanding the seller's motivations, and formulating an appropriate offer, a buyer can scoop up an asset quickly and for good value. A mistake some buyers commit is to not be satisfied with obtaining an asset at a bargain price, instead pushing for rock bottom prices. The result often is the creation of very strong motivation for the seller to generate competition for the buyer. Once the competing buyer arrives, the market (and, unfortunately for the initial bidder, far higher) value of the asset emerges. A similar result can occur when buyers push for unreasonable representations, warranties, or other conditions in the purchase agreement. Distressed sellers, in particular, place high value on certainty and on limitation of future liabilities. For example, an ABC assignee can be found to be in violation of their duties if they enter into a transaction that includes warranties or indemnification allowing the buyer to reach into the estate. Successful buyers are always realistic in their requests for terms and conditions from the seller. For example, if the buyer is concerned about the title to assets acquired out of a self-liquidating company, instead of asking for representations the seller is unable to deliver, the buyer can demand that the sale be consummated through an ABC or a bankruptcy proceeding.

Summary

The crisis in global financial markets is creating unprecedented opportunities for buyers of intellectual property. Sophisticated buyers are taking advantage of these opportunities to bolster their intellectual property portfolios, as well as to add new products and technologies to their companies. By understanding the unique conditions of sellers of these assets, and the processes they employ, buyers can successfully acquire intellectual property which will benefit their business for years to come at excellent value.

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