IP DUE DILIGENCE IN M&A TRANSACTIONS: HOW TO AVOID ANOTHER ROLLS ROYCE

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A recent *Harvard Business Review* article stated that: "Deal making is glamorous; due diligence is not." It went on to say: “That simple statement goes a long way toward explaining why so many companies have made so many acquisitions that have produced so little value.” One of the most extreme examples of IP due diligence gone wrong happened in 1998, when German car maker Volkswagen purchased the assets of Rolls Royce and Bentley for about $900 million. Volkswagen did not realise until after the deal closed that the IP assets did not include the right to use the Rolls Royce trademark – the mark was owned by another car maker, BMW, pursuant to a prior agreement. Volkswagen had therefore acquired all the rights necessary to manufacture the car, but did not have the right to brand it as a Rolls Royce.

This Rolls Royce story highlights the critical role of IP due diligence in the acquisition process, and should serve as a reminder to M&A corporate teams, especially with the recent rise in acquisition activity. The year 2014 is shaping up to be a record year for technology acquisitions, with Facebook’s $19.4 billion acquisition of WhatsApp marking the largest technology sector acquisition this year and the sixth-largest on record. According to an investment banking research firm Dealogic, global technology sector M&A volume stands at $93.7 billion in 2014 to date, almost double the volume in the same period in 2013 ($48.2 billion). Software is the most targeted subsector within technology, with $39.8 billion in volume via 525 deals. Services ($23.6 billion) and semiconductors ($6.1 billion) round out the top-three targeted subsectors.

Doing the deal

Acquisitions are risky deals. In a seminal 1987 study, Harvard Business School professor Michael Porter found that companies sold off many more acquisitions than they kept. He also found that companies with acquisition strategies reduced instead of created shareholder value. Later studies reinforced Porter's conclusions. A KPMG study conducted 15 years later found that more than 80% of mergers were unsuccessful in producing any business benefit, as measured by shareholder value. That study further identified due diligence as one of three key activities that successful acquirers had prioritised in the pre-deal phase, and that had a tangible impact on their ability to deliver financial benefits from the deal (the other two were synergy evaluation and integration project planning).

Although acquiring companies often assemble large teams and spend lots of money analysing the size and scope of a deal in question, the fact is that the momentum of the transaction is hard to resist once senior management has the target in its sights. Due diligence all too often becomes an exercise in verifying the target's financial statements rather than conducting a fair analysis of the deal's strategic logic and the acquirer's ability to realise value from it. Seldom does the process lead managers to kill potential acquisitions, even when the deals are deeply flawed. The lack of prioritisation of IP due diligence further compounds the problem. Corporate, tax and accounting issues often take precedence, and by the time the deal team starts to review the intellectual property, the deal structure has already been set.

IP due diligence panel

The topic of IP due diligence was discussed in a panel that I moderated at a Silicon Valley IP conference. The panel included some of the largest corporate buyers, along with corporate lawyers and IP consultants with knowledge of M&A due diligence activities. The panel members all agreed that the process of IP due diligence, in the context of corporate M&A deals, should be moved to the critical path, both in terms of timeline (earlier in the deal) and importance. The panel further identified several major topics that could be addressed to streamline the IP due diligence process.

Raise awareness of risks associated with acquired IP portfolio

Given the general risk associated with acquisitions, technology deals are even riskier than average because of the complexity of the products involved. The IP portfolio is a key asset in technology deals, much more so than in any other deal.

IP due diligence is therefore absolutely critical to managing risks associated with a deal. Knowing the risks associated with a flawed IP due diligence process can go a long way towards encouraging senior management to allocate more resources to the process. Lack of licensing rights or forged inventor assignments are two examples of serious problems with IP portfolios of acquisition targets that could have devastated the post-deal integration had they not been found through the due diligence process.

IP assets should be incorporated in valuation of target

IP assets are treated as an afterthought and usually do not drive the value of the target. This is an unacceptable situation when it comes to high-tech acquisitions. Several of the panelists mentioned the fact that investment bankers and other financial advisers participating on the deal often sideline issues that could alter the value of the deal or complicate the process. It is therefore the case that IP assets are not evaluated and priced separately from the target, but rather are priced after the deal is concluded for financial reporting purposes, where the price of the deal needs to be allocated among the various assets purchased with the target. IP valuation is a general issue that hinders many transactions, due to the lack of efficient markets for intellectual property and the lack of transparency when it comes to reporting IP deals and the valuation considerations that went into pricing them. Having said that, any quantitative assessment of the IP portfolio, even a rough value range, will go a long way towards improving M&A due diligence and understanding the value of IP assets in the pre-deal phase.

Integrate seller in process

Considering the seller’s post-deal indemnification exposure with respect to the representations and warranties given in the transaction agreement, sellers should have a vested interest in the IP due diligence process. Sellers should be integrated in IP due diligence in a way that would help both sides streamline the process in a more efficient and cost-effective way. Panel members representing buyer organisations mentioned that, from a seller's perspective, better presentation of IP assets will help the sellers to get better terms for the deal, which is not necessarily in the buyer’s best interest. That is an interesting point to keep in mind, as the buyer’s and seller’s incentives are not always aligned.

In the 15 years since the Rolls Royce due diligence fiasco, IP assets have grown in importance as value drivers in high-tech M&A deals. However, as many of those involved in transactions may attest, buyers and sellers are still a long way from fully accounting for the risks, value and strategic importance of IP assets involved in acquisitions. It may take another fundamental oversight such as Volkswagen's for IP due diligence to become more strategic to deals.

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