Intellectual Property

Challenges faced during divestitures from the Monitor/Trustee's perspective

When antitrust or anti-competitive concerns surface during a merger or post-merger investigation by federal or state regulatory agencies, respondents may be required to divest selected assets. The divestiture of the tangible assets – the physical plant and equipment; the products or services; the human resources; and the customer community – may not be sufficient to promote future competition in a given market. Some of the biggest challenges facing regulators involve the intangible elements of the business – the Intellectual Property needed to assure long term viability and competitiveness.

The underlying objective of the divestiture is to assure that the company acquiring the business (or product lines) and associated Intellectual Property will be a strong competitor in the future. This may involve the relatively straightforward divestiture of patents or licenses; but could also entail a situation where the products in the asset package share Intellectual Property with a set of products retained by the seller. To be a viable competitor, the company managing the divested assets will need not only external, temporary protection but the internal capabilities consistent with leveraging the Intellectual Property acquired.

This paper will look at some of the factors that influence whether a divestiture that includes Intellectual Property will be successful.

Antitrust and Intellectual Property

The antitrust community is continuing its efforts to delineate the appropriate intersection of antitrust laws and Intellectual Property (IP) rights. Most of the issues currently being addressed involve the balance between the property rights afforded by patent protection and the application of the power inherent in these rights in anticompetitive ways. Nonetheless, the shared goal is apparent.

> ***"The intellectual property laws and the antitrust laws share the common purpose of promoting innovation and enhancing consumer welfare."***
> \- Antitrust Guidelines for the Licensing of Intellectual Property, Issued by the DOJ and FTC, 1995

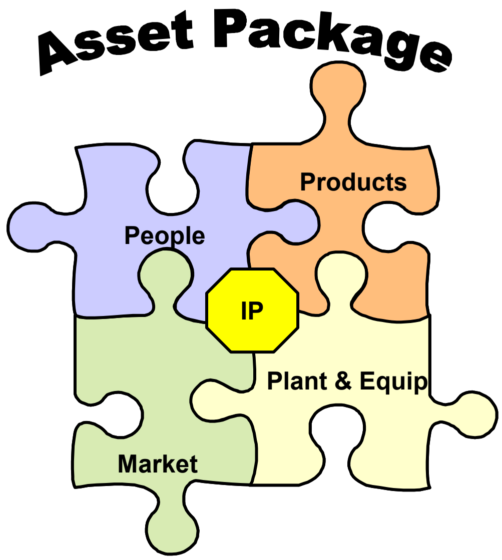
Despite this common purpose, there are a number of situations in which antitrust liability may be incurred. These include the enforcement of patents obtained fraudulently; inappropriate patent licensing; certain patent litigation settlements; and specific schemes deployed to use the patent law to violate antitrust laws. Some of these schemes consist of the following actions: the refusal to deal in an essential facility; cross licensing for the sake of price fixing or market allocation; and the abuse of a standards setting process to establish market dominance. Currently, the majority of the active FTC adjudicative proceedings deal with either patent litigation settlements (such as Schering-Plough/Upsher-Smith) or an alleged abuse of the standard setting process (such as Rambus and Unocal). In such cases, regulators historically have applied a variety of remedies which may include the divestiture of IP, settlement registration, cessation of pursuing infringement claims, compliance programs, disgorgement, and royalty-free licensing of IP.

One area of antitrust litigation that is less controversial involves the competitive remedies resulting from the review of mergers and acquisitions. The rules regarding the competitive impact of intellectual property in mergers and acquisitions are normally a function of the dynamics in a given market. In some markets, particularly those with high levels of innovation, the control of intellectual property is a primary predictor of market share and significant consideration is given as to how to remedy the situation. In others, those with low levels of innovation, control of intellectual property may not be as closely scrutinized. In the following sections, some lessons learned on the role of intellectual property in assuring a successful divestiture are explored.

Divestiture Success

What is a successful divestiture? In general, regulators seek to establish a viable competitor, a minimum of ongoing entanglements between buyer and seller, and the maintenance or enhancement of competition in a relevant market. Most seller's want a minimum of transition related pain, value for the assets being divested, and an end to the regulator's involvement. Most buyers want a minimum of transition related pain, a high return for their investment, and a fair and competitive marketplace after the divestiture.

In a traditional divestiture, success largely hinges on three factors – the Asset Package, the Acquirer, and the Transition. This paper concentrates on the first and most critical element, the Asset Package.



For a successful divestiture, the Asset Package must focus on ensuring the buyer gets the right people; products; market access; customers; supplier partnerships; and physical assets such as plant and equipment. IP exists at the intersection of all of these categories.

Experience in monitoring forced divestitures that include intellectual property has led to the identification of a number of unique challenges as well as approaches to enhance the probability of a success in the divestiture of IP. These can be broken down into the following four categories:

- IP Identification
- IP Divestiture Method
- IP Support
- Acquirer Qualification

IP Identification

In the evaluation of the technological forces that create innovation in the market, the identification of the IP that is required to make a new competitor viable is the first critical step. This doesn't stop with the recognition of patents, copyrights, and trade secrets; but must also consider the intellectual property in the development pipeline. The review of the development pipeline should identify those next generation products (and associated IP) which could make divested products and IP obsolete. This assessment needs to be broader than merely reviewing current "in process" patent applications; but should include potential new technological applications under development in the R&D process.

To assure a robust future for the divested business, regulators should consider the question: “Who has the rights to the patent pipeline?”

One recent case illustrates this issue. The divested business is in a small, highly specialized market. Prior to divestiture, the regulator, interim monitor and acquirer performed a detailed review of the products and IP to be divested. It was not until nearly one year after divestiture that management identified a key missing piece of IP that had been excluded. This took place only when a former executive from the seller joined the acquirer and the importance of the missing IP was recognized.

Taking full advantage of “20/20” hindsight, how could this have been prevented? A glib answer would be “additional due diligence.” Unfortunately, no level of diligence will catch everything every time. Additional input from members of the development staff most familiar with the IP may have identified this item, particularly from those employees designated to be transferred to the buyer. A different approach would have been to include in the order a post-divestiture obligation to license any existing IP or IP in development for a limited period of time if later identified to be relevant to the divested business.

A second example involves a highly successful effort to share IP between buyer and seller. In this case, the item consisted of a customer management software package which had been developed in-house and had capabilities unique to the industry. Although the separation of data and functionality required a large effort by the information technology staffs of both organizations, after the split both parties were initially satisfied. Yet even in this example, there were challenges: a major upgrade was in the development pipeline prior to the divestiture but not included as an “asset to be divested.” Within weeks of the successful separation, the seller had the enhancements from the upgrade in place. The buyer now had to decide whether to dedicate scarce development resources to catch up, or to live with the existing product. In this case, the upgraded capabilities were not viewed as a competitive differentiator and the buyer made the decision not to devote resources to this effort. However, this highlights the fact that if the development pipeline is not adequately considered, the result can be a buyer that is disadvantaged.

IP Divestiture Method

Once the IP to be included in an asset package is identified, the regulator needs to consider the appropriate method of divestiture. If the IP is to be shared between buyer and seller, should the seller retain the rights and license to the buyer, or should the buyer be given the IP rights and license back to the seller? Is a patent pool appropriate? Should licenses be perpetual? Should licenses be royalty-free? Which party has the rights to license to others in the market? Is the license assignable? Should the agreement include grant backs?

These decisions are important ones for they impact not only the value of the business but its future viability as well. In many cases, the intent of the enforcement by antitrust regulators is not to eliminate the innovator’s premium resulting from the IP, but instead

to avoid elimination of a competitor in a horizontal market. Properly structured, the divestiture will ensure a market continues to exist that allows an innovator's premium to be collected by both buyer and seller.
A second reason to pay particular attention to the divestiture method is to prevent either the buyer or seller to, solely due to the divestiture structure, eliminate the other's ability to compete. There are a number of ways in which one party could adversely affect the other party's ability to compete. These include the development of patent improvements or extensions and refusal to license; development of defensive patents, such as patenting related items that would be used in new products thus limiting long-term competitive viability; sub-licensing into the divested assets' markets, reducing the competitive advantage of the patent in those markets; and breaking the divested products into key components in order to sell those components in the divested assets' market or aftermarket. While these can all be legitimate business strategies, the method used to divest IP must assure that a level playing field is created for both buyer and seller.

There is not one recommended approach, for the answers to these questions will depend on the specifics of the case. In some cases, it makes sense to leave the decision entirely to the buyer and seller as they negotiate the terms of the deal. This is especially true if the parties come to the transaction with equal capabilities. However, should the buyer be either a new entrant to the market or in some other way disadvantaged, extra attention needs to be paid to the terms of the IP divestiture. As most buyers are eager to gain regulatory approval, presentations to the regulators normally focus on strengths and may exaggerate capabilities. It is often only after the deal closes that shortcomings come to light.

IP Support

Intellectual Property - absent the people, business processes and know how - can be worthless. In order for the divestiture to be successful, the buyer needs to get the intellectual capital required to take full advantage of the IP. This can include personnel involved in development, marketing, and the managing of the business – especially those who develop IP strategy. This is all the more important when patents and copyrights are supplemented by related trade secrets. Problems associated with insufficient intellectual capital transfer have arisen multiple times in recent cases.

In one recent case, the buyer believed it had negotiated sufficient personnel to properly run the business. It wasn't until well after the deal was closed that gaps in knowledge and specialized intellectual capital were identified. These gaps prevented the acquirer not only from taking full advantage of all the divested IP, but also from extending the IP in order to remain a viable future competitor. This gap was not recognized initially due to the fact that the buyer's strategy at acquisition was not focused on product growth, but merely on maintaining the existing product. Fortunately, the order allowed for the staffing issue to be re-visited and key personnel were transferred post-divestiture to fill in the gaps. Even with the additional personnel, the buyer ended up somewhat light on intellectual capital. Only after a top management had time to absorb the acquisition did the true importance of intellectual capital come to be recognized. The buyer went on to fill gaps through external hiring.

Another piece of IP support involves litigation. Probably the most typical example is the ability to effectively defend patents from infringers. A more unusual example was recently experienced, in which a third-party filed suit against both the buyer and seller based on IP developed by the seller. The case was typical for the industry, but the buyer was unprepared from a legal standpoint to defend itself.

A Held Separate Business offers a very different perspective on IP support. In a recent case, a merger was allowed to proceed while those businesses to be divested were set aside and held separate. While the core business was required to continue to provide support, in the course of the merger key service organizations were combined which led to a cessation of support in one critical area.

Issues regarding IP support can be addressed in a number of different ways. Litigation support, for example could be covered through an obligation of the parties to jointly defend all challenges to the patent. The insufficient personnel issue was actually well addressed in the order in that the buyer was allowed to re-examine its personnel needs post divestiture. The problem in this specific case was more related to the buyer's capabilities and knowledge of the business. Finally, in the HSB situation, the resolution was also available under the order, but required active intervention by the Trustee to ensure the seller complied. The lesson from all of these examples is that absent supporting structures, the divestiture of IP alone may not achieve the goal of creating a viable competitor.

Acquirer Qualification

An in-depth assessment of the buyer's internal capabilities and competencies needs to take place prior to approving the divestiture to a given acquirer. This review needs to address the following questions:

- Does the buyer understand the underlying science and technology involved?
- Does the buyer have the ability to integrate the IP into the current product portfolio; new products; and into adjacent and new markets?
- Does the buyer have the ability to develop patent extensions and improvements for long-term viability?
- Does management have the needed experience and knowledge to fully exploit the value of IP?
- Does the company have the manufacturing capability, processes, and supply chain partnerships to gain a competitive advantage?
- Does the company's sales force have the sophistication to take advantage of market opportunities?
- Does the ability to leverage the technology into other regions, such as international markets exist?

- Is the company of a sufficient size, scope and depth to take advantage of scale economies?
- Does the ability to identify violations and defend the patent exist?

Summary

The ability to exploit the IP, either through the existing capabilities of the buyer or through intellectual capital that is acquired as part of the divestiture, is a critical success factor in an IP divestiture. In addition, IP needs to be divested in such a manner that provides sufficient protection for both the buyer and seller to continue to earn an innovators premium. Finally, the capabilities of the acquirer to take advantage of the IP, either internally or through acquiring the appropriate intellectual capital with the Asset Package need to be validated.

The topic of Intellectual Property rights is a difficult one, specifically when dealing with patents which allow corporations to achieve competitive advantage in a given marketplace. As such, the net impact of most forms of Intellectual Property rights is to reduce competition for a period of time in a specific market. Given that the charter of most regulatory agencies is to prevent anticompetitive business practices, it may appear to be contradictory to use Intellectual Property rights to maintain or re-introduce competition in selected markets. We realize that the regulator must walk a fine line between establishing a viable competitor and replacing one market imbalance with a different market imbalance. The assignment of Intellectual Property rights can be a powerful tool in correcting potential market harm, and neglecting to deal with the Intellectual Property implications of a merger can result in proposed remedies not achieving their desired goal.

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