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Buyout Brainstorm

A new breed of IP lawyer, combining corporate law smarts with IP expertise, is playing a growing role in private equity deals. Buyout firms used to ignore the potential profit—or disaster—that resided in the intellectual property of a target company. No longer.

By John Bringardner

Lori Lesser is a fast talker. Really fast. An intellectual property litigation partner in Simpson Thacher & Bartlett's New York office, she could conceivably bill twice as many hours a year if she spoke as slowly as the average person back home in Houston. But then again, if she slowed down, she wouldn't be able to keep up with the torrent of IP work created by Simpson Thacher's huge private equity deal flow.

In the past few months alone, Lesser has overseen the carving-out of 25,000 patents from Royal Philips Electronics N.V.'s semiconductor unit into a stand-alone company and worked on IP matters for the Blackstone Group L.P.'s $3.3 billion acquisition of the pharmaceutical technologies and services business of Cardinal Health, Inc., as well as its $4.3 billion acquisition of Cendant Corporation subsidiary Travelport.

Private equity shops like Kohlberg Kravis Roberts & Co., Blackstone, and The Carlyle Group are pouring a seemingly endless flow of cash into deals—in total, U.S.–based firms spent $421.7 billion worldwide on mergers and acquisitions in 2006, according to data from Thomson Financial. A small but growing portion of that money is finding its way to intellectual property attorneys and strategists, as buyers recognize that the main assets changing hands in many of these deals are intangible. The need-it-yesterday pace of this transactional work opens the door to hidden IP dangers that may only come

Dan McCurdy is CEO of ThinkFire, an intellectual property licensing and advisory firm. Half his time now goes to private equity clients.

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to light long after the deal is done. Lawyers don't have the time to examine an IP portfolio very closely, and things might be missed. But in the meantime, the barbarians at the gate have discovered the importance of IP in their deals. Their needs are reshaping law firms, demanding a new breed of lawyer: the corporate IP attorney.

"There's a huge field of practice that most people call IP corporate or IP transactional, which involves combining deep and credible IP skills with corporate," says Edward Black, a partner in the corporate department of Ropes & Gray and cohead of the firm's Fish & Neave IP Group. (Ropes & Gray acquired IP boutique Fish & Neave in 2005.) IP firms such as Fish & Richardson are hiring corporate attorneys, and general practice firms are devoting more IP attorneys to deal work, a practice that is shredding outdated stereotypes that contrasted the action-addicted personality of a deal lawyer with the science-wonk IP attorney. Black also points out that IP lawyers can no longer simply be divided into litigators or prosecutors. Corporate IP attorneys bring a combined skill set into play. "It's everything you'd expect a big corporate attorney to know, but they also know IP, and they're using all those tools around portfolio management," he says.

The money is also flowing in from new directions. Private equity deal work used to come to IP specialty firm Finnegan, Harrison, Farabow, Garrett & Dunner mostly from existing corporate clients who were readying themselves for sale. But lately, says Esther Lim, a partner in Finnegan's D.C. office, "we've seen more buy-side work directly from the private equity firms themselves, and I imagine we'll see more."

They're not alone. Foley & Lardner's Boston office has nearly doubled in size over the past two years to 65 attorneys, and most of that is attributable to IP work on private equity deals, says Gabor Garai, who chairs Foley's private equity and venture capital practice, and is cochair of its life sciences team.

In most private equity deals, the corporate IP attorney's work falls into three buckets: due diligence, contracts, and IP strategy. These lawyers are brought into deals at the due diligence step to conduct a preliminary inspection of a target company's portfolio just before an offer is made. The IP attorneys work in close consultation with technology experts at the private equity client to make sure that the investors are getting what they think they're getting. "We always do a search on the IP assets to find liens, claims, any big 'gotcha' contract provisions," says Darren Collins, an IP partner at Patton Boggs in Dallas, who has done work for such private equity clients as American Industrial Partners and Milestone Capital Management. "But the number of instances of also doing a deeper dive into the technology has increased substantially," he says. "We've had deals that were killed because of IP issues."

Recent patent verdicts have focused more attention on the risk of IP litigation. The $612.5 million settlement that RIM Ltd. paid to NTP, Inc., last year still resonates loudly at private equity firms.

Due diligence has always been a part of deal work, but the size of recent patent verdicts has focused more attention on the risk of IP litigation. The $612.5 million settlement that Research in Motion Limited paid to so-called patent troll NTP, Inc., last year still resonates loudly at private equity firms. "People are more afraid of trolls now than the portfolios of their competitors," says Lesser, the Simpson Thacher partner. "People are much more afraid of the one well-positioned sniper than the nuclear bomb."

The technology sector is particularly laden with patent-holding companies, and private equity money has taken notice. There were about 150 private equity deals involving technology companies in 2006, with a deal volume of $30.6 billion, according to Bloomberg. These days, as private equity deals appear to have no size limit, companies such as Texas Instruments Inc. and Motorola Inc. are on the private equity radar screen—well-established, publicly listed technology companies with hefty patent portfolios and complex licensing agreements.

Karen King, general counsel at tech-heavy private equity firm Silver Lake Partners, says troublesome IP issues come up "maybe 20 percent of the time." If a red flag arises, the lawyers and the would-be bidder quickly determine if the problem is a deal breaker. "Very rarely is it anything serious," says King, "because it's usually public companies we're looking at. If they did have something terribly wrong, it would be in the public documents."

But due diligence work isn't just a rubber stamp from an IP attorney. John Kappos, an O'Melveny & Myers IP partner who spends more than half his time on private equity transactions, says his work involves risk assessment, determining the likely outcome of ongoing litigation. "Sometimes it does get into looking into the [target] company's IP estate to look at monetizing patents, or to figure out if they're covered for commercial activities or if they'll have competitors in their market," he says. "All of those various factors tend to have some bearing on how venture capital or private equity firms put a valuation on these investments. But the freedom to operate or litigation risk is by far the most important factor in valuation, and exclusivity is secondary."

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Kappos cites his work analyzing ongoing litigation at Biomet, Inc. The company, which designs and manufactures joint replacements, was acquired for $10.9 billion last December by a private equity consortium consisting of GS Capital Partners, L.P., The Blackstone

Group L.P., TPG Capital, and Kohlberg Kravis Roberts & Co. O'Melveny represented the consortium as IP cocounsel, while Cleary Gottlieb Steen & Hamilton led the deal overall on the corporate side. With patent infringement lawsuits ongoing against Biomet, Kappos looked at the products accused of infringement and the relevant patents, and figured out what was likely to be the outcome. (It's the first time O'Melveny has been brought into a case with Cleary as cocounsel, says Kappos.)

But he also strikes a note of caution, because due diligence doesn't give lawyers the time or the mandate to analyze a portfolio the way litigation does. "In these transactions you usually wouldn't scrub clean an issue the way you would in litigation," says Kappos. "Buyers don't want to spend the money, because they're not in a litigation, typically."

Once the parameters of the portfolio have been established in due diligence, the second bucket comes into play: contract negotiations. The buyout of an entire company is relatively simple, as far as IP contracts go, with all rights bundled into one package.

Where things get tricky—and IP lawyers are crucial—is in negotiating contracts for carve-out deals, in which one section of a company is spun out of a parent company. For instance, such concerns came into play in the case of Avago Technologies, Inc., a semiconductor company created in 2005 when KKR and Silver Lake Partners acquired the group from Agilent Technologies, Inc. (itself a 1999 spin-off from Hewlett-Packard Company).

"On a large deal, those are fairly substantial undertakings," says Jeffrey Norman, a partner in the Chicago office of Kirkland & Ellis who says that at least half of his work is engineering the IP side of private equity deals. Corporate IP attorneys describe contract negotiations as the most exciting, if exhausting, part of the deal. "Often you are doing this on a very tight timeline, on very little sleep, and with people who are excited and nervous," says Lesser.

Carve-outs require attention to how licensing agreements will be affected, often across thousands of patents, all within a matter of weeks. Contract negotiations run the gamut: the terms of cross-licensing agreements, out-licensing, IP allocations, noncompete agreements, and employee agreements. "When you're buying the company you either want it or you don't, so you make sure, first and foremost, you're not walking into a trap," says Lesser. "When you're buying just a piece of the company, you often share IP through cross-licenses with the parent."

Last July, shortly after Dutch technology giant Royal Philips Electronics announced it was selling its semiconductor business, a large cast of players moved into gear. Over the course of about a month, Philips, six private equity firms, and four law firms—not counting those representing the lenders—hammered out the details of what would become a $10.68 billion deal. Dozens of trans-Atlantic flights and conference calls across six time zones ensured that the new company carved out of Philips, a semiconductor maker that became known as NXP b.v., could become a stand-alone business and a solid investment for KKR, Silver Lake, Alpinvest Partners, Inc., Apax Partners, Inc., and Bain Capital, LLC. The private equity consortium acquired 80.1 percent of the company, with Philips keeping the rest. But as part of the deal, NXP took with it more than 25,000 patents and licensing deals within the Philips Group and across other companies that had to be disentangled. While not going into the details of this particular transaction, Lesser says that a lot of times the parent owns the IP that covers the products of the carve-out, as well as the IP for some related products that the parent still owns. As a result, a cross-licensing arrangement is critical and often complicated. (NXP is now a portfolio company of the consortium, and a Simpson Thacher client.)

Carve-outs of one company from another pose really tough IP work. Negotiations can require untangling many thousands of patents and licensing arrangements.

The third bucket of work appears just before the deal is done, and can continue long after the deal is closed. In taking a company private, the goal of private equity investors is to create a healthy return on investment in a time horizon of five to seven years. PE funds often narrow the company's focus, trim costs, and find new revenue streams. An important part of that process, especially with technology companies, is IP portfolio management—making sure that the company has a proper IP infrastructure in place for managing the existing portfolio and acquiring new patents.

"It's the engineering-the-company bucket, which is my favorite," says Norman, one of five partners in the corporate IP practice at Kirkland, which also includes six junior-level partners and about 25 associates. Kirkland has steadily built its IP practice over the past decade and handles most IP matters for its private equity clients. Norman worked on Parthenon's acquisition of Rackable Computers in 2003. The company had weaknesses in several of their patents, so Norman filed several continuations to broaden their claims. He was then able to get injunctions against competitors who were infringing the patents. Though he handles the strategy, Norman says he frequently outsources opinion work to boutiques Brinks Hofer Gilson & Lione and Staas & Halsey. Lori Lesser at Simpson Thacher often relies on boutique Sughrue Mion for patent opinion work. She also regularly works with ThinkFire, a Warren, New Jersey–based intellectual property licensing and advisory firm.

Dan McCurdy, ThinkFire's president and CEO, has worked on four deals with Lesser in the past year. ThinkFire has done ten or so private equity deals in the past 18 months, typically hired directly by the private equity firm. This work now makes up about half of ThinkFire's consulting business, something McCurdy says he never expected when he started the company in 2002. "Most of our work was for high-tech companies, advising them on how to improve their business operations," he says. ThinkFire sees itself fitting in between market strategy firms, that advise on the business landscape, and law firms that outline the legal risks. "We give the private equity firms a realistic view of where the most valuable IP lies in the target," says McCurdy.

Some private equity firms have considerable patent smarts in-house. Elevation Partners, which invests in media and entertainment companies, acquired and merged video game makers BioWare Corporation and Pandemic Studios because it thought it could profit from the company's

IP portfolio. British private equity firm Coller Capital recently launched a subsidiary, Coller IP Capital, staffed by Peter Holden and Eric Shih, both of whom came from IPValue Management, an IP consulting firm. IPValue itself was formed in 2004 with investments from the private equity arm of Goldman Sachs and General Atlantic Partners. General Atlantic describes itself as a private equity firm providing capital for companies "driven by information technology or intellectual property."

An archetypal example of botched IP due diligence: Volkswagen bought Rolls-Royce Motor Cars Ltd. in 1998, but only later realized its purchase didn't include the trademark. The potential for a similar blow-up haunts today's corporate IP lawyers.

There are other firms whose explicit mission is to fund patent litigation, such as Altitude Capital Partners and NW Patent Funding Corporation.

"For the first time, traditional institutional money is chasing IP," says Ron Laurie, a former Skadden, Arps, Slate, Meagher & Flom partner who now heads Palo Alto–based Inflexion Point Strategy. In the past 18 months he too has become more deeply involved in corporate deals driven by IP, both private equity and corporate mergers and acquisitions. A lot has changed since Laurie left Skadden in 2004, where he did due diligence work for private equity firms such as Blackstone. He says that in the past, IP analysis only came in on the tail end of the deal. "Now IP is starting to wag the dog," he says. "I left Skadden because I was doing a lot of M&A, and I was frustrated that IP was always at the end of the deal after the price had been set. It was bizarre that these were companies where 98 percent of the market capitalization was intangible, and nobody was looking into the IP."

But for all the increased attention IP is getting in transactions these days, there's no guarantee that all the work is being done well. A litigator, for example, could get rattled by a tempo of work much faster than what he is used to, while a Ph.D. in chemical engineering, who usually prosecutes patents, may have trouble understanding the strategy of a deal. "Some people are better than others at corporate IP work, and frankly, not all 200-plus lawyers in the IP group [here] are good at it," says Foley & Lardner's Garai. "There's a self-selection process and a training process." Industrywide, the pool of experienced corporate IP attorneys is smaller than the work available, which means that there are people doing the work who don't have much experience.

While not a catastrophic problem, some IP attorneys point out that private equity firms are still missing out on maximizing the potential of a target's IP portfolio. David Feldmeier, a former IP manager in the legal department of Avago Technologies, says KKR and Silver Lake didn't take full advantage of Agilent's patent portfolio when they carved out Avago. "It may just be that the size of the deals they're working on is so big that they'd rather take 80 percent of the value now, rather than 95 percent of the value a few months from now," he says.

There's also the ever-present potential for a colossal blow-up. One archetypal example of botched IP due diligence that haunts today's lawyers occurred in 1998, with Volkswagen AG's purchase of Rolls-Royce Motor Cars Ltd. Volkswagen took control of the manufacturing plants, the engineering plans, the workers, but only later realized that the deal did not include rights to the luxury automaker's famous trademark. Meanwhile, BMW bought the Rolls-Royce trademark, and Volkswagen was forced to lease the rights to the brand name it had thought was part of its original $712.7 million deal. It's this kind of embarrassing gaffe—and the threat of malpractice suits—that all of the law firms working in corporate IP want to avoid.

But for the moment, there's a lot of lucrative work to be done. Private equity firms raised $156 billion in new money last year, and they are looking far and wide across IP–heavy industry sectors to make deals. Ron Laurie remembers a time when "the last thing bankers wanted in the early part of the deal were lawyers." These days, corporate IP attorneys don't have to fight for their place at the table. ■

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