

“Commercial” versus “legal” approaches: alternative strategies to resolving third-party IPR issues confronting new ventures.

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Abstract

For many technology-based ventures, whether classic start-ups or corporate ventures, the viability of the business rests on intellectual property rights (IPR). The costs of registering and protecting IPR are well documented and often present a significant obstacle for entrepreneurs to overcome. In addition to these are the costs of inappropriate forms of due diligence, often involving IPR investigation, evidenced in the work of Molian and Solt (2002). "Conventional" due diligence outcomes involving IPR can create a limited set of options leading to the abandonment of a promising opportunity, where IPR - in particular patents - owned by a third-party are seen as the major stumbling-block.

In this paper the authors present alternative, "commercial" approaches to dealing with the issues of third-party IPR ownership, which can circumvent the original problem. Unfortunately such strategies are often not considered by advisers. The approaches examined are based on examples drawn from the automotive industry, but the authors argue that both principles and application have wider relevance across industry and in particular to resource-constrained start-up businesses.

Introduction

Formal due diligence has an important role in assessing the viability of many embryonic new ventures, and in particular those which involve the commitment of funds from external investors. In our conception of formal due diligence we follow Molian and Solt (2002), where it is defined as “the process by which the parties to a commercial transaction identify, document and mitigate all aspects of legal and commercial risk prior to undertaking that transaction. Each party to the transaction typically employs its own legal and financial advisers, whose prime duty is to protect the commercial interest of their clients.” The same authors observe that this process is often asymmetric, in that the resources of corporate and “professional” investors, such as venture capital houses, are typically greater than those of the investee business, and such investors are able to spend more money on the expertise of specialist advisors.

The thrust of Molian and Solt's argument is to question the appropriateness of what they describe as *large-scale* due diligence approaches applied by corporate investors in situations that call for *small-scale* approaches. (For an overview of the large-scale process, see Angwin 2001.) The large-scale due diligence approach is seen to be based on that used in mergers and acquisitions, the small-scale approach being a contrasting approach appropriate to the very different circumstances of a new or emerging venture. In both situations there are *two stages* of due diligence activity before the new entity can start to function as such. The first stage is the identification and assessment of all risks and liabilities, the structuring of the venture and the outline negotiations. The second stage is the preparation of the detailed documentation that results from agreement between the parties.

The case considered by Molian and Solt is investment by corporations in third party ventures, commonly known as external corporate venturing. In this paper we use the same notion of appropriateness in due diligence, and expand it to cover any investment made in a new venture – whether internal to the investor or external – which is heavily dependent on access to and exploitation of intellectual property rights (IPR). In particular we are concerned with the first stage of the due diligence process, the identification of risks and liabilities. Molian and Solt have argued that the large-scale due diligence approach is directed principally at identifying and quantifying historic risks and liabilities, with two outcomes that are unhelpful in the context of new ventures. The first of these is excessive expense, as lawyers rack up fees investigating matters of little material consequence which nevertheless appear on the due diligence checklist. The mere expectation of such costs can often diminish the attractiveness of a potential investment¹. The second adverse consequence is excessive focus on the past and on inherited risks and liabilities. In the case of new ventures, an appropriate due diligence process will by contrast focus on the future, and on mitigating future risk while helping to maximise future chances of success.

Due Diligence and IPR

In a science- or technology-based venture, much of the future expected value is likely to reside in the exploitation of IPR. In such cases a major item of expenditure pre-commercialization is likely to be the registration and protection of these rights. A large part of the first stage due diligence process, therefore, will be concerned firstly with confirming the new venture's claim to good title of any IPR assets and, secondly, to assessing whether IPR possessed by a third-party is likely to stand in the way of exploiting those assets. A description of the process typically involved is given in Martinez de Andino et al (2004).

This “discovery” process, as it is often described, may well find that a potential obstacle exists in the form of third-party IPR, which blocks the commercial exploitation of the new venture's assets. The discovery process is normally in the hands of an IPR specialist, either an employee of the investor or an agent engaged externally, who reports his or her conclusions. In cases of such a roadblock, conventional wisdom then concludes that this is indeed the end of the road and the

¹ These authors cite one such case where the investor's advisers' fees approached the level of the actual investment required.

investment cannot proceed, or that the possible options are constrained. Assuming that this advice is heeded, the attractiveness of the proposition is greatly diminished. If the funder withdraws, both the venture's promoter(s) and the investor are then left out of pocket and a promising potential venture either returns to the funding market or withers on the vine.

The contention of this paper is that such cases also constitute an example of inappropriate due diligence. Alternative "commercial" approaches exist, which place more emphasis on marketplace realities and less on a narrow conception of the due diligence process.

Patents as Roadblocks

Before considering these "commercial" approaches, it is useful to briefly review the conventional "legal" approaches to dealing with third party patents. Possibly as a result of the term "intellectual *property*", patents are often compared to fences that surround and keep competitors off a patch of technological real estate (Knight, 1996). However, in many business situations – particularly outside of pharmaceutical and chemical technologies – it is more appropriate to visualize a patent as a roadblock, blocking the path of a third party to an invention with its associated market advantages. Such an approach is supported by Micklethwaite (1946) who describes the purpose of a patent claim as "mak[ing] it as difficult as possible for a potential infringer to get the advantages of the invention".

Using the roadblock metaphor, the conventional "legal" approaches to overcoming third party patents can be viewed as either destroying or bypassing the roadblock. "Destroying" involves submitting evidence to the patent authorities that the patent is invalid and should be revoked - once a patent has been invalidated, it can no longer be used to prevent others from practising the invention (for an overview of the grounds on which a patent can be invalidated and data on the relative occurrence of the various grounds see Hartwell 2002). "Bypassing" involves finding an alternative way of achieving the market advantage of the invention. Both approaches can be costly and time-consuming, as illustrated by the example in box 1.

Source Data

Evidence for the "commercial" approaches detailed below comes from a recent, wider survey into third party patent infringement clearance practices in UK and German companies, part-funded by the Research Fund of the European Patent Organisation. Companies from the automotive sector were chosen with a view to investigating anecdotal reports of significant variation in practice in this sector, in particular variation in patent opposition behaviour between UK and Germany companies.

The automotive sector was also chosen on the grounds that there are a significant number of in-house IP departments that, it was felt, would give a better insight into actual "commercial" practice than would smaller companies advised by external lawyers. As noted by Molian and Solt, a lawyer's basic duty of care is to protect the interests of his client which, in the absence of other instructions, are best protected by

minimising the client's risk. This, it was suspected, would prompt external lawyers to state what *should* be done according to their understanding of the law rather than what is *actually* done in real companies subject to real budget and time constraints.²

The survey was also carried out on the understanding that the survey would focus on process rather than legal issues, that participant's identities would not be published and with an offer to enter into a confidentiality agreement. In the event, interviews were obtained with the heads of ten in-house IP departments in the UK and Germany, only one department requiring a confidentiality agreement to be signed.

There follow details of three manoeuvres, used by various of the companies surveyed, for overcoming third party patents. Whilst these approaches are not necessarily what one might anticipate or indeed recommend from a purely "legal" point of view, they do nevertheless reflect the "commercial" reality in the automotive industry. Moreover, it is the authors' belief that these manoeuvres have wider application and may be of particular help to entrepreneurial companies with their typical budgetary constraints.

Manoeuvre A: Get through while the patent roadblock is under construction

Under European patent law, a patentee can only prevent third parties from practicing an invention (by means of a court injunction) once a patent application has been granted by a patent office – "once the patent roadblock is complete", to use the earlier metaphor. This in turn only takes place once the patent application has been examined to confirm that the invention meets the criteria for patentability (primarily that the invention is both new and non-obvious). This examination process typically takes several years, during which time the patent roadblock may be considered to be "under construction". Nevertheless, the patent statutes make clear that third parties can still be liable for infringement of a patent application while it is under examination and that a patentee can demand compensation ("damages") for such infringement once the patent application has been granted.

The survey has revealed that, in the automotive field, not all companies are put off by these legal penalties. Where - as is often the case with niche products - a production run is short and the third party patent application is still at an early stage in examination, it was found that a company sometimes proceeded with production on the basis that this would end before the third party patent application came to grant. In terms of the metaphor, the company gets through while the patent roadblock was still under construction.

This manoeuvre is facilitated by several factors, the first of which is an average time from initial (priority) filing to grant of 48 months for European patent applications in the field of automotive technology (the average time for all technologies is 55

² The latter suspicion was borne out at an early stage when an approach to a small but heavily IP-dependent automotive company in the UK was rebuffed on the grounds that "this is a sensitive area and our (external) patent attorneys have advised us not to participate".

months³.) A second factor is the limited production run, which allows a realistic financial provision to be made for the damages likely to be payable in the event that the patentee pursues a claim once the patent is granted. This of course assumes that the patentee discovers the infringement – comments from those surveyed suggest a wide variation in the extent to which companies actually police infringement of their intellectual property.

Unlike the second and third approaches discussed below, the “get through while the patent roadblock is under construction” manoeuvre does not *remove* risk. In particular, there remains the possibility of a determined patentee, having detected infringement, asking the European Patent Office to expedite examination with a view to completing the patent roadblock before production has finished. Nevertheless, the survey suggests that – in the automotive sector at least – this first approach can be commercially justified.

Manoeuvre B: Booby trap the patent roadblock

The conventional “legal” approach of destroying a patent roadblock involves a company firstly assembling evidence and arguments against the validity of the patent and then submitting that material to the patent authorities in order that they might issue an official revocation of the patent.

The survey has revealed an alternative approach in which the patent roadblock, rather than being destroyed, is merely booby-trapped: evidence and arguments against the validity of the patent are assembled by the company as before; however, rather than being sent to the patent authorities, this material is sent to the patentee together with an invitation to grant the company passage through the patent roadblock (typically implemented by means of a free of charge licence). Should the patentee refuse this invitation, the booby trap is sprung, the evidence and arguments being sent to the patent authorities in order that they might consider revocation of the patent.

Assuming the patentee chooses to grant a licence, such an approach has obvious cost advantages for the company - an idea of the potential costs associated with a conventional challenge to a third-party patent can be gained from the case study in box 1. The patentee also saves the costs of defending a conventional challenge.

Box 1 : Challenge by Ricardo Consulting Engineers Ltd to the validity of European patent no. 0 846 945 (“Procedure for analyzing the driving behaviour of vehicles”) belonging to AVL List GmbH.

<u>Date</u>	<u>Legal Step</u>	<u>Estimated Cumulative Cost (Euro)</u>
12/1996	AVL file priority patent application in Austria	

³ The European Patent Office (2009) states that, on average, a granted patent was published 43 months after the application was received, the figure varying from 36 months for Vehicles and General Technology to 60 months for Biotechnology. It is assumed that most applications are received at the end of the “priority year”, 12 months after initial filing.

11/1997	AVL file corresponding patent application with European Patent Office	
01/2001	Ricardo submit evidence to the European Patent Office (EPO) as to why the patent application is invalid	2000
12/2001	Ricardo submit further evidence	4000
06/2002	European patent no. 0 846 945 granted to AVL	
03/2003	Ricardo file opposition to European patent	12000
02/2005	Ricardo submit further arguments and evidence	16000
03/2006	Ricardo submit further arguments and evidence	24000
04/2006	Ricardo and AVL attend hearing at EPO	29000
	EPO Opposition Division decides to revoke patent	
08/2006	AVL file appeal	
03/2007	Ricardo file response to appeal	34000
09/2007	Ricardo and AVL attend hearing at EPO	39000
	EPO Board of Appeal upholds appeal, sends patent for further opposition	
06/2008	Ricardo submit further arguments and evidence	44000
07/2008	Ricardo and AVL attend hearing at EPO	49000
	EPO Opposition Division decides to maintain patent in amended form	
10/2008	AVL file appeal	
05/2009?	Ricardo file response to appeal?	54000?

There is, however, a further advantage for the company in that the patent roadblock remains in place to deter other companies from following the same route: had the roadblock been destroyed by a conventional legal challenge then everybody – not just the company filing the revocation request but also that company’s competitors – would know that the invention of the patent was free for use.

The “booby trap” manoeuvre does not find favour with everybody. The patent authorities would prefer to see invalid patents publicly revoked so as to ensure that patents are granted “only for innovations having sufficient inventive merit and meeting the needs of society” (European Patent Office, 2009). The “booby trap” approach also requires a company to bring itself to the attention of a patentee and for this reason was not favoured by all companies surveyed, some preferring to reserve their evidence and arguments until such time as the patentee accused them of infringement (which often did not occur, not least because the patentee did not police for infringement). However, from a risk management point of view, this latter approach is less satisfactory as it does not *remove* risk, unlike the licence that may be obtained using the booby trap manoeuvre.

Manoeuvre C. Get a big brother to let you through the patent roadblock

The last manoeuvre identified by the survey is truly “commercial” in that it takes no account of the validity or examination status of the patent in question. Instead, a company uses the commercial strength of a partner (a “big brother”) to persuade the patentee to grant the company passage through the patent roadblock.

Companies using this approach in the survey were typically automotive component suppliers, their partner usually being a large automotive OEM. When faced with a third-party patent roadblock preventing the company from supplying a certain product to the OEM, the company would ask the OEM to ask the third party to grant the company a licence.

The success of this approach depends heavily on the commercial relationships between the parties. In the absence of any existing relationship between the OEM and the third party, and assuming that the third party is itself in a position to supply the OEM, there is little incentive for the third party to grant the requested licence. If, however, the third party is already a supplier to the OEM, then the threat of sanctions, for example the loss of future business, may persuade the third party otherwise. Similarly, the OEM is only likely to make representations on the part of the company if it has a common interest with that company, typically the need for a second source of components to ensure security of supply.

As mentioned, this manoeuvre does not affect the validity of the patent, so that there is no incentive for the patentee to grant the company a free licence, as might be the case with the “Booby Trap” manoeuvre. Nevertheless, even a licence for which the company has to pay will still remove a risk to the company’s business.

Conclusion

As noted by Molian and Solt, as well as getting right the “why” (strategic rationale) and “how” (execution), a successful venture needs to understand the dynamics of inter-dependent relationships which will drive a new business to success.

The latter is particularly true of IP-dependent technology businesses: whilst they certainly need to know “how” to secure patents, this alone will not achieve success. Rather, such businesses also need to understand the commercial relationships that will allow them to realize value from their patents on the one hand and maintain freedom to operate in the face of third party patents on the other.

Set out above are three types of relationship for maintaining such freedom to operate in the face of third party patents. Although derived from a survey of large corporations in the automotive industry, it is the authors’ contention that the both the principles and application of these relationships have wider relevance across industries and to businesses large and small.

Indeed, it is arguably more important for resource-constrained start-ups to be aware of lower cost “commercial” alternatives to the conventional “legal” approaches that might immediately be apparent from the patent statutes with which their legal advisors are familiar. The ability to deal with an infringement risk in a cost-effective manner may make the difference between a successful investment or the enterprise withering on the vine.

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