

Helpful Hints on Buying Technology

Acquiring intellectual property has pitfalls which can be avoided with foresight

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There are many ways of acquiring intellectual property: by hiring researchers, using consultants or research contractors, obtaining patent and know-how rights; and buying a going business that has developed the pertinent intellectual property. The primary thrust of this paper is to treat those circumstances where it is desirable to acquire intellectual property in the form of technology or industrial property, comprising patent rights, manufacturing know-how, technological trade secrets and related hardware in various stages of development.

WHY ACQUIRE?

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Let's first look at some of the situations where you don't want to acquire intellectual property.

Quite frequently, a company employing long-range planning techniques, such as quantitative trend analysis, normative forecasting and input-output grid analysis, will be drawn to product and market areas showing great promise in the future, but which are foreign to the current business operations of the company. This is the classic situation where a company which lacks capabilities in an unfamiliar business area will want to acquire a going business possessing the necessary expertise. Thus, General Electric recently decided that the future held great prospects for the energy resource industry. Rather than start a venture from scratch, GE acquired Utah International, a mineral exploration and process firm. Last year, Pfizer, the pharmaceutical concern, decided that the fast-growing medical X-ray field had a profitable future. Pfizer acquired Radiological Sciences as a technical and marketing base upon which to expand.

The extent to which the research, manufacturing, marketing and general management capabilities required for new product development overlap the company's existing capabilities determines whether internal product development will be a failure, mediocre or successful. As a rule of thumb, internal product development becomes too costly and risky, even with the help of outside consulting and subcontractor firms, if more than two of these four major capabilities are lack-

ing for meeting the specific know-how requirements of the new venture.¹

When only one or two of these four major capabilities required for the venture are incompatible with company personnel resources and know-how, the acquisition of a going business is no longer necessary, however, acquiring industrial property may still not be the answer. In the situation where the new venture involves an unfamiliar area of technology or manufacturing, the acquisition of industrial property for internal development may be unwise. Outside R&D and pilot plant facilities with the specific expertise needed for the testing, prototype development, manufacture and training of company personnel represents the least risky route.

When a new venture stems from short-range business planning, the need for second-generation equipment, employee suggestions, unsolicited ideas or the research laboratory, the venture will normally involve technology and manufacturing know-how that the company already possesses. In such instances, the company is capable of assimilating and successfully commercializing acquired industrial property with little or no risk, assuming the firm also has the marketing and general management capabilities to sell the product it develops.

The auto industry represents a classic example of know-how and patent acquisition for internal product development. Two dozen auto companies throughout the world obtained licenses to develop, tool and mass produce the Wankel rotary engine. General Motors reportedly entered into a license agreement for the payment of \$50 million. Mazda was the first licensee to complete internal development and tooling to introduce the rotary engine car to the market. Last year, American Motors paid Volkswagen for the rights to the know-how, equipment and tooling to internally develop the 2-liter, 4-cylinder engine for its Gremlin.

In February, Foster Wheeler, a maker of air and water pollution controls, agreed to acquire European air pollution technology from CECA, S.A., a French pollution control manufacturer. The new technology will enable Foster Wheeler to enter new markets based on precipitator technology to remove particulate matter from fossil fuel burning smokestacks.

In both the auto and pollution cases, the acquiring companies had the necessary technical expertise and manufacturing capabilities to develop and produce the products themselves, but instead chose the quicker and less risky route of buying proven technology.

When making your trade-off analysis between purchasing technology for internal development and buy-

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ing a going business, you must look ahead as to how you want to grow in the venture area. If the company initially chooses to get into the new area through internal growth, this can cause problems in the future if it wants to make an acquisition of a going business to round out or expand its venture.

This year; the FTC challenged Bic Pen's proposed purchase of the Phillip Morris American Safety Razor Division. The reason for seeking a District Court order to block the transaction was that Bic Pen, which recently entered the field with a disposable razor, might substantially lessen competition and restrain trade. Thus, you may be wise to acquire a going concern right off the bat rather than get into external growth gradually and risk an antitrust charge that you are now a potential competitor or market entrant.

Of perhaps even more serious concern is that the acquisition of technology itself may be an antitrust violation. Acquiring patents and trade secrets by purchase or exclusive license comes under the scrutiny of Section 7 of the Clayton Act.² This law prohibits the acquisition of such assets where the effect thereof may be to substantially lessen competition or to create a monopoly.

Whether there is a substantial lessening of competition depends on:

1. The nature, value, and number of legal monopolies which are externally acquired in relation to the total number of legal monopolies in the relevant competitive market area.

2. Whether such acquired legal monopolies were being commercially utilized prior to acquisition thereof by the former owners or licensors or whether there were plans for utilization thereof.

3. The actual anticompetitive effect product in the relevant geographic and product market.

A treble-damage counterclaim by a defendant in a suit for infringement must show injury stemming from the restraint on competition as opposed to prosecution of the infringement suit which the previous patent holder could have also brought.³

WHAT PRICE?

The price of acquired technology is usually influenced by several factors: the purchaser's need criteria, the seller's expenses, market forces and tax considerations.

The acquirer's major need criteria are his desired ROI, investment payback period and annual after-tax net profit. For instance, if the buyer wants a five-year payback period and it will take another two years before the buyer can commercially market the technology, the buyer will not want to pay a purchase price of more than the first three years of after-tax profit that is anticipated. Also, if the buyer expects a return on his investment of at least 25% per year, he will not want to pay a purchase price of more than four times the anticipated after-tax net profit from the venture.

The seller's costs less legitimate depreciation of tangible property such as production prototypes and appreciated by rising replacement costs represents a realistic baseline as far as the book value of the industrial property is concerned. The seller's motives for divesting or exclusively licensing the industrial property

determine whether more or less than the book value should be paid. For instance, if the seller has a personal need to get out of the business or raise money or if the seller has failed to complete technical development for one reason or another, the seller may be interested in unloading the technology at a price below book value. On the other hand, if the technology has been completely developed, if it has been proven in a limited manner such as in a test market or by a previous licensee and if the seller's aspirations are accordingly high, the price may be many-fold higher than the book value.

Market forces can generally establish a realistic compromise position between the buyer's needs for a relatively low investment and the seller's aspirations to make a killing on its valuable R&D. For instance, the market value of the stock of public companies in the same technology/market area is an indicator of the fair market value multiplier being used. In other words, the ratio of the stock price to earnings per share represents the multiple of annual profits that the market considers reasonable for an investment in this technology. The ratio of the stock price to book value indicates the multiple that the marketplace considers paying for an investment in this technology with regard to assets. Of even greater impact would be the direct activity in the marketplace for bidding on the technology being offered by the seller. Such bidding immediately establishes an arm's length fair-market value.

Tax considerations play a vital part in arriving at the final purchase price as well as the manner of payment. The buyer wants to pay as little front money as possible and stretch out the purchase price in installments or preferably in periodic payments the amount of which is contingent upon conditions subsequent. For instance, the contingent pay-out may be attempted where the seller is providing technical assistance to achieve certain specified goals in completing development of the technology. The contingent payout may simply be based on the buyer's usage or sales.

However, the sellers may no longer tolerate such pay-outs if Congress enacts legislation currently pending to prevent capital gains treatment in such instances notwithstanding that there is a complete sale and transfer of the industrial property. For instance, Section 107 of H.R. 1040 (introduced by Representative Korman) amends 26 USC 1235(a) to prevent capital gains treatment where the consideration is payable over a period of time coterminous with the buyer's use of the patent rights of contingent on productivity, use or disposition of the industrial property.

One final word on what form the payment can take once a figure is reached. As stock prices continue to climb beyond their 1974 levels, it becomes attractive to issue paper for an acquisition as opposed to hard cash for internal development. The higher the stock price, the fewer shares that have to be issued for the agreed upon purchase price. This leaves the buyer free to use its cash for further development of the technology and venture start up.

PRACTICAL TIPS ON CLOSING⁴

The buyer must guard against any clause in the clos-

ing document that allocates the purchase price to capital assets, such as patent and know-how rights and capital equipment. Although the seller wants to have as much capital gain as possible (instead of ordinary income at the higher tax rate), it is in the buyer's interest to allocate as much of the purchase price for the acquisition away from such depletable or depreciable assets which cannot be currently deducted from taxable income as ordinary and necessary business expenses in that year.⁵ Thus, as much of the purchase price as possible should be allocated toward prototypes, inventory and other property being acquired that does not have a useful life greater than the year of the sale.

Certain warranties that are not essential in licensing agreements take on importance in the closing document of an acquisition. For instance, the corporate charter and bylaws of certain companies require action by the Board of Directors before property can be sold. The seller should be required to warrant that the execution of the closing document has been duly and validly authorized by its Board of Directors and that no further corporate action is necessary to make the sale valid and binding. Warranties become important where new technology being acquired includes tangible property in addition to intellectual property rights. The seller should be asked to warrant that capital equipment and prototypes are in good operating condition. Furthermore, to make sure that the seller is not unloading obsolete technology, the buyer should insist upon a warranty that the seller does not know of better or alternative know-how at present, whether in-house or elsewhere.

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Another way to make sure that the seller is not divesting itself of second-rate technology with the intention of developing a more advanced product in the future is to include post-covenant restrictions in the closing document. Thus, the seller should be asked to promise that it will not compete with the product or venture based on the bought technology for a reasonable period of time (for instance, five years). This restriction should also be extended to transferees of future technology that the seller develops that would result in a competitive situation.

In an acquisition, it is not enough to extract a promise from the seller to provide technical assistance

needed as the buyer continues development work. The seller should promise in writing that it has made no future employment arrangements with and will not solicit its researchers and other technical personnel that the buyer must bring along with the acquired technology in order to make a smooth transition.

Lastly, no acquisition should be closed without the assurance that the buyer has adequate recourse for breach, misrepresentations and other problems that arise. A portion of the purchase price could be held in escrow as security for indemnification for a reasonable period of time enabling the buyer to make sure that the tangible and intangible assets are not damaged or substantially decreased in value for any reason. If R&D still needs to be carried out to a large extent, the buyer may find it wise to include a contingency clause in the closing document that would allow future installment payments to be lowered should significant problems be encountered which are not quickly solved by the seller's technical assistance. It is also important that the buyer be assured that it can obtain an injunction to force the seller to perform its part of the bargain in providing the technology, technical assistance and other things called for in the closing document rather than merely be awarded damages from a court of law upon finding a breach upon the part of the seller. This can be done by adding a clause to the closing document that the seller agrees that violations of its obligations cannot be adequately compensated by damages because of their extraordinary character and that the buyer shall be entitled to injunctive relief and the seller will not urge the defense that there is an adequate remedy at law.

NOTES

1. See Sperber, *Intellectual Property Management: Law - Business - Strategy* (Clark Boardman Co., Ltd., New York City 1974), Section 2.01(1) for a detailed analysis and diagram explaining the make-or-buy decision.

2. *Western Geophysical Co. of Am., Inc., v. Bolt Associates, Inc.*, 305 F. Supp. 248, 305 F.Supp. 1251 (D. Conn. 1969).

3. *Dole Valve Co. v. Perfection Bar Equipment, Inc.*, 165 USPQ 337.

4. See Sperber, *Negotiation in Day-to-Day Business* (American Negotiating Institute, New York City 1976), pp. 82-83 for additional suggestions on closing the deal that is favorable to you.

5. Section 167 of the United States Internal Revenue Code.