Patents Can Bridge Valuation Gaps in Acquisitions

Acquirers want to pay less money for targeted companies than sellers wish to receive. Thus, valuation gaps often need to be bridged for acquisitions to close. While there are several frequently used valuation gap bridging mechanisms, patents are one overlooked tool to boost purchase prices when contingencies come to fruition.

Seller financing is one tool that enables buyers to pay less than sellers hope to receive at closing. With seller financing, sellers loan the buyer part of the purchase price. In return for committing to repay such seller notes, buyers benefit because they need to come up with less money at closing. In some cases, sellers don't have a choice. If they want to sell their company, they may have to provide seller financing. In other cases, sellers may be able to charge interest rates in excess of their costs of capital while their receipts of deferred payments may be taxed at lower rates.

Earn-outs are another tool that is widely considered when valuation gaps need to be bridged. Let's say that the owners of Omega Corp. want to receive at least $60 million and the buyer, Bridgestone Fund, wants to pay no more than $50 million for Omega. As it turns out, Bridgestone doesn't have a management team available to parachute into Omega and run that business. Bridgestone also greatly respects Omega's three senior-most executives.

Upon further contemplation, Bridgestone would like the three Omega executives to run that business for two years, during which time these executives would train Bridgestone's appointed managers. All three of the Omega executives want to continue running the business. If all goes according to plan, a smooth transition will be achieved in two years.

But before any transition happens, the three legacy managers need to be compensated and motivated to grow the business during ensuing twenty-four months. So, the parties may agree to an earn-out.

Earn-outs are designed to compensate the managers for the value they generate during the transitionary years. Earn-outs can be structed in a myriad of manners. The managers can receive:

- A given percent of Omega's revenues.
- A given percent of Omega's revenues above its recent historic average revenues.
- A given percent of Omega's revenues from new customers or new products.
- A given percent of Omega's cash flow.
- A given percent of Omega's cash flow above Omega's recent historic average cash flow.

Earn-out payments can also be triggered by non-financial milestones. For instance, payments can be made when:

- Production hits predesignated markers.
- Defect rates or customer service complaints fall below delineated thresholds.
- Website traffic hits certain numbers.
- When regulatory clearances are achieved.
- When awards are received.
- When more retail shelf space is captured.

While earn-outs work in theory, they seldom work in the real world. Many business owners don't mesh with acquirers' organizational structures. Founders are after all an entrepreneurial bunch; they don't coddle to micromanagement, reporting to bosses or submitting to performance reviews. Managers compensated with earn-outs often feel that their decision-making authority is restricted by new owners who want to centralize decision making and consolidate operations. Such tensions can be felt when the motivated managers believe that reductions in research or marketing budgets were responsible for their divisions failing to meet their bogies. Financial metrics can be manipulated or misunderstood, causing debilitating dissention. Some say that earn-outs are simply invitations to litigation.

So how can owners of patent-rich companies negotiate total effective closing prices closer to the $60 million exits they desire? There are two measure that Omega's owners should consider far in advance of taking Omega to market.

One is placing Omega's patents in a holding company. Omega could then withhold its patents from the sale and then license its patents to Bridgestone, at least for the fields of use necessary for Omega to continue its legacy operations.

Another idea is commissioning a Patent Valuation Report, ideally more than a year ahead of marketing efforts. The risk of not having a Patent Valuation Report prepared is that so few investment bankers (and even corporate acquirers) understand patents, the value of Omega's patents are likely to be swept under the rug. On the contrary, a valuation report would help Omega's owners articulate the value of their patents. A report prepared prior to the corporate sales efforts would likely be considered more objective than a report prepared during the throws of negotiations. If it is too late, both parties could agree to pay for half of the Patent Valuation Report, in return for having equal access to the valuators preparing the report so that both sides could share their impressions of the patents.

Below are several context-driven ideas for providing Omega's owners with additional compensation if certain contingencies are met.

Proceeds received from infringers, net of litigation costs, can be shared between Omega and Bridgestone if they cooperate with each other during patent litigation or settlement discussions against infringers. (Omega might be expected to police the market, prepare claims charts, share prior art and perform some damages analysis.) Omega could seek better terms if the patents were successfully asserted against designated archrivals of Bridgestone. In a similar vein, Bridgestone may agree to pay Omega some predetermined amount of money if the patents sustained an invalidity attack.

Bridgestone could agree to compensate Omega's owners if the patents are successfully used to cause the International Trade Commission to impound inbound infringing products at America's ports. Similar terms could be applied if the patents trigger injunctions, forcing competitors to cease selling infringing products.

If Omega has a patent application on file that covers what appears to be a hot new product, Bridgestone could agree to make a large payment to Omega's owners if that application issues with one or more claims that are not narrowed due to amendment during prosecution.

Suppose Bridgestone takes possession of the patents and uses those patents to collateralize a low-interest rate loan. In that scenario, Bridgestone could agree to share some of the interest payment savings with Omega.

Bridgestone could agree to share some of its proceeds with Omega's owners in the event the patents are licensed to a licensee for a new field of use. Similarly, proceeds could be shared in the event that sublicensees are recruited to serve geographic markets currently unserved by either company.

In any event, the owners of Omega should refrain from assigning its patents to Bridgestone until final payoff (a license may be needed to bridge the time from closing to payoff) or agree to include the patents in the acquisition on an encumbered basis (typically with a lien) until final payoff.

In conclusion, patents are akin to options. A lot can be done with patents. Patents can form the kernel of new products and restrict others from emulating such products. Patents can be licensed. Patents can be asserted against infringers. Patents can collateralize loans. The publishing of patents can block rivals from obtaining similar patents. Companies can boast about having patented products or a sizeable patent portfolio.

Large companies confronted with heightened anti-trust scrutiny are acquiring smaller tech/AI/fintech companies without technically acquiring them. That is, the big companies are hiring the employees at the small companies and licensing the small companies' technologies and IP. For instance:

- Google agreed to a $2 billion licensing fee for Character.AI's technology
- Amazon agreed to pay $330 million to license Adept AI's technology
- Microsoft paid around $650 million to license Inflection's technology

Patents can enable foreign companies barred from importing their merchandise into a given country (due to trade wars) the ability to derive royalties from domestic distributors. Patents can enable companies that are forced to abandon significant investments in researching new technologies with a toehold in relinquished markets. (That is, they stand to achieve royalties from companies that later commercialize inventions in their abandoned fields of pursuit.) Patents can be used to achieve price concessions from suppliers who are caught infringing. Above, I explained a variety of means by which patents present options to sellers of businesses. However, just as with options, patent owners are not required to do anything with their patents. Patentees can let their patents expire simply by refraining to remit maintenance fees or annuities.

Business owners who do not appreciate the value of patents in bridging valuation gaps are at risk of leaving significant money on the table when they go about selling their companies.

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