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Patent Diligence for VCs and PEs

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Frequent viewers of the hit U.S. reality television series *Shark Tank* will recognize one of the sharks' most commonly asked questions: "Do you have a patent?" They'll also know that discussions of patents on the show tend to be brief and superficial, potentially giving viewers the impression that merely owning a patent is sufficient to provide strong intellectual property protection – a box to be checked on the road to closing a deal. But real-world patent diligence is significantly more complex, requiring investors to probe deeply into a company's patent claims, its patent portfolio, its internal patent policies and procedures, and its ability to monetize its products and services while minimizing patent infringement risk.

Why Care About Patents?

Why should investors care about patents beyond confirming that a company has them? The right patents can significantly enhance a company's value, offering investors and the market a sense of security and confidence. They serve as tangible assets that can carve out a market niche and protect it from competitors. But the value of patents goes far beyond serving as a basis for filing infringement lawsuits. Patent owners can also license their patents – even if they're not actively using them – thereby creating additional revenue streams from assets that might otherwise remain dormant. Moreover, building up a patent portfolio can generate, and demonstrate, substantial knowledge about the state of the art and the industry landscape. Patent owners can use that knowledge to clear the path for new products, navigating and potentially eliminating competitors' patents. Many companies also use their patents as marketing tools, since potential customers tend to view "patented" or "patent pending" products as being more exclusive and higher quality than others.

What Makes Patents Valuable

Some patents are stronger than others, and investors should know how to differentiate good ones from bad ones.

Bad patents often include a long background in the specification (i.e., the written description of the invention), which can be construed as applicant-admitted prior art, making the patent more difficult to defend in later litigation. Ideally, an investor should be able to read the specification and immediately understand what makes the invention compelling; specifications that bury the invention story by jumping straight into technical details or using language only patent lawyers understand are detrimental. Another common characteristic of bad patents is narrowly drafted claims. While narrow claims can make patents easier to obtain, they restrict the scope of the coverage, rendering the patent easier for competitors to design around. Restrictive language, such as claims that refer to the invention as the "present invention," can limit their enforceability in litigation. Closed prosecution

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can also indicate weakness. In the U.S., it is possible to obtain multiple patents from a single patent application by claiming different aspects of the original invention in continuation applications. Closing prosecution without pursuing continuation applications can restrict the patentee's ability to draft additional claims in the future.

Conversely, good patents share several recognizable traits. A powerful invention story in the specification serves as a marketing tool, allowing investors to read it and understand its value while also creating a compelling narrative for juries in future litigation. Robust disclosures show that the patent was drafted not just with the current product in mind, but also future products, while the use of flexible language allows the patentee to add claims covering different product components later. A key characteristic of strong patent claims is that they are drafted with infringement in mind, making each element of the claims as easy to prove as possible. The claims should identify direct infringers and address how others might contribute to or induce infringement. Questions of infringement often turn on claim construction, so the claims should also take into account how a court is likely to construe them.

Beyond individual patents, investors should consider the strength of the company's patent *portfolio*. A valuable patent portfolio comprises multiple patents in the same or different families and includes patents with strong claims and robust disclosures that cover current products, future products, potential competitor products, and industry gaps. The portfolio should keep pending applications alive to allow continuations, enabling future patents to be crafted with infringing products in mind. If the company operates or plans to operate outside the U.S., the portfolio should also include patents or pending applications in major markets abroad.

Recognizing a Company That Will Create Valuable Patents

Investors do not need to create valuable patents themselves – at least not before the investment. However, they should be able to recognize the characteristics of companies that have processes in place to create valuable patents. While each company's policies are different, they should be designed to accomplish each of the following objectives:

- **Educate** management and employees about patents and the value of a strong patent portfolio. Teach employees how to incorporate "patent thinking" into their day-to-day activities.
- **Cultivate** a pervasive companywide attitude that patents are vital to the company's future. This attitude starts from the top down and requires management buy-in; employees must *believe* management's claims that patents are essential for long-term growth.
- **Harvest** patentable ideas by capturing R&D and turning it into patents. Common patent harvesting methods include (a) the use of standard invention disclosure forms, (b) a patent group that liaises with engineers to obtain more detailed invention disclosures, and (c) periodic harvesting meetings with individual R&D groups to identify patentable inventions.
- **Select** the best ideas for patenting using a patent review committee that meets periodically to review and vet invention disclosures. The committee should comprise a cross-section of the CTO, patent experts, and at least one employee with comprehensive knowledge of the company's technologies, products, and history. Each member of the committee should have "mapping" knowledge about how the company's issued and pending patents map to its current products, its competitors' products, and its future products.
- **Reward** inventors with payment and recognition. For example, set up a rewards system with different levels of rewards for achievements in the patenting process, such as submitting an invention disclosure form, filing a patent application, and obtaining an issued patent.

Ensuring freedom to operate

A patent is a right to exclude others from making, using, selling, offering for sale, or importing into the U.S. the invention claimed in it. It is *not* an affirmative right or a license for its owner to do the same. To illustrate this distinction, assume that Company A patents a chair, with the chair comprising a seating surface, four legs,

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and a back. Company B adds arms to the chair and claims in its patent a chair comprising a seating surface, four legs, a back, and two arms. Company B cannot make, use, or sell its chair without infringing Company A's patent, while Company A cannot make, use, or sell a chair with two arms without infringing Company B's patent. Freedom to operate (FTO) – i.e., the right to practice the patented invention without infringing anyone else's patents – is thus an essential consideration when evaluating the value of a company's patent portfolio.

Companies can mitigate FTO issues by conducting an FTO analysis – a type of risk assessment that aims to identify potential patent barriers to the commercialization of a product or service. An FTO analysis is a snapshot of the market and can reveal how likely it is that a company's products or services can avoid the valid claims of others' patents. FTO analyses typically encompass the following steps:

- Identifying active patent(s) claiming an invention that may be considered similar to the proposed product
- Comparing the claims of the identified patents to the proposed product to determine the risk of infringement, including both literal infringement (i.e., the proposed product includes every element of a claim) and doctrine of equivalents (i.e., the proposed product includes equivalents of the claim elements)

In some instances, patent attorneys categorize the identified patents according to the level of infringement risk they pose. For high-risk patents, companies may also seek a validity analysis to determine their strength and how likely they are to survive patentability challenges.

An FTO analysis is a good sign that a company has done their due diligence and is not attempting to build a future on shaky legal ground. However, investors should be aware that companies are often reluctant to share the results of their FTO analyses because doing so can result in the loss of attorney-client privilege and make the analysis discoverable in future litigation. While there are certain methods to reduce that risk, investors should expect pushback when seeking the results of an FTO and keep in mind that pushback does not necessarily mean the results are bad.

Summary

Patents don't matter for all investments, but in certain sectors, they are pivotal. It's not the mere possession of patents that counts, but the strength of their claims and alignment with the company's goals. Looking into a company's patenting practices, procedures, and culture can offer strong evidence as to the robustness and utility of its portfolio. For critical, high-value products, FTO analyses can inform the viability of market entry and the risk of legal roadblocks. Investors should therefore do more than simply ask companies whether they *have* patents; they should consider patents as part of a comprehensive risk and value assessment, given them the diligence they deserve as cornerstones of a company's value.

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