



## Patent due diligence: Process and priorities – A Canadian patent attorney's perspective <sup>☆</sup>

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### ARTICLE INFO

#### Keywords:

Patent due diligence  
Patent searches  
Licences  
File wrappers  
Opinion letters  
Timescale  
Patent jurisdictions  
Duty of disclosure  
Freedom to operate  
Patent families  
Translations

### ABSTRACT

This article provides a broad-ranging Canadian patent attorney's perspective of the highly challenging area of patent due diligence work and of how to manage the conflicting priorities of a due diligence project. It is suggested that the work be approached in stages, each of which is explored in some depth:

1. Examine the formalities of filings of interest, focus on primary jurisdiction(s) and primary portions of technology, review any key licenses and permissions related to the technology.
2. Carry out an in-depth review of file wrappers; consider whether any opinions are necessary and if so initiate searching; substantively review relevant assignments and employment contracts; expand the scope of investigations to additional filings/jurisdictions as appropriate.
3. Prepare preliminary versions of any opinions, carry out any investigations required to go behind the documentation that has been reviewed.
4. Expand and formalize any opinions as needed; carry out or request any remediation that may be appropriate; finalise any reporting letters that may be required.

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### 1. Introduction

Although investors are becoming more conscious of the value of IP and of some of its characteristics, when the time comes to assess a patent portfolio expectations are often wildly unrealistic. There are always conflicting demands with regard to cost, timeline, and the level of certainty achievable on a limited budget. Many papers have been written on the subject of due diligence [1–4] but they generally give little guidance on how the process can be managed in a real world situation. Usually work has to be done to a limited budget and counsel are forced to set priorities and guide the client as to which elements of a comprehensive (and expensive) due diligence project, are essential and which can potentially be put on the back burner. This paper briefly reviews some selected issues in pat-

<sup>☆</sup> Thanks to the following individuals for their assistance and suggestions: George Chan of Rouse International in Beijing, John Rissman of Rissman, Jobse, Hendrix and Oliverio, Yawen Liu, Steven Slazyk, Fred Sierecki and Jeanine Tse, all of Davis LLP. This article is loosely based on a presentation given for the IP Summit in Vancouver, in September, 2008 <<http://www.davis.ca/publication/Patent-Due-Diligence-Presentation-to-IP-Summit.pdf>>. This article is provided for general informational purposes only and does not constitute legal advice. Content may be incomplete or misleading in relation to specific circumstances, or as you may interpret specific circumstances. No decisions should be taken without consulting a properly qualified professional adviser fully informed as to the circumstances in issue.

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ent due diligence and makes suggestions as to how the process may be broken down into stages and the work prioritized to balance conflicting priorities<sup>1</sup>. This is by no means a checklist, these can be readily obtained or compiled from articles and resources available on the internet [5–7] and from more comprehensive books on the subject [8]. While written generally from the viewpoint of a party acquiring a patent portfolio, this paper will also help vendors better prepare themselves for due diligence.

It is always desirable to have IP counsel involved from the earliest stages of a deal. Even if a client elects to do a good deal of the investigatory work itself, the advice of counsel can improve the focus and efficiency of any investigations and can facilitate negotiating a solid term sheet. On the vendor's side, it creates a much better impression if a target company is able to provide prompt, comprehensive and clear information regarding the status of its portfolio. On the purchaser's side, having a better picture of the target's IP from the outset can make it much easier to know where to draw the bottom line in negotiations, and where there may be leverage in negotiating the deal. In both cases, it is preferable to have the parties start negotiations with their eyes open, rather than spending months deciding the outline of a deal and only then commencing due diligence and finding their assumptions were wrong.

<sup>1</sup> Editor's note: A recent article in press presents a patent searcher's perspective on the patent due diligence process (Hantos S. Helping others acquire, license or invest in patents with confidence – a guide for patent searchers to patent due diligence. World Patent Inform 2010;32(3):188–197).

In the best scenario, a target company will have regularly audited and documented its IP portfolio, so that when due diligence is carried out there will already be a detailed and accurate roadmap available, all the significant documentation will be ready to hand, and the target will already have answers prepared regarding any material concerns that may exist. Unfortunately, in the real world, due diligence is sometimes viewed as an unnecessary expense and counsel as troublesome naysayers. Counsel for all parties to a transaction are often presented with something close to a “done deal” and asked for advice within a minimal time period and when neither party is keen to reopen discussion of significant terms. Given that counsel are usually asked to do the impossible, in an unreasonably short timeframe, and on a unrealistic budget, it is vital to set priorities and have some sort of a plan that can be presented to the client so that the most critical questions are answered first.

## 2. Conflicts of interest and privilege issues

Conflict and privilege issues should be kept in mind from the outset.

A transaction often involves conferences and exchanges of correspondence with multiple variously associated parties (for instance, the client, the underwriter, a second investor) whose entitlement to information and advice may vary. Be mindful of the identity and interests of the participants, what information is disclosed and to whom questions and answers may be addressed. It is very easy for the lines between parties to become blurred and for potential conflicts to arise.

In Canada there is no patent agent privilege, and the same is true in a number of other jurisdictions. Consequently any consultations with Canadian and other foreign patent agents may be subject to discovery elsewhere, the most usual concern being US litigation. Thus many advise their clients to avoid written records of verbal consultations, so that they cannot be dragged up in future litigation. By the same token, it is sometimes possible to construct a self-serving written record for particular purposes.

## 3. Strategy

Determine who are going to be the contact people at each party, and establish immediate objectives and some sort of timeline. Due diligence necessarily proceeds in stages, which can be broken down in many alternative ways, and may be adjusted to reflect aspects of the transaction or for budgeting and scheduling purposes. By way of example it may be convenient to initially divide the process into the following four general stages whose content is flexible and overlapping and will change to reflect the transaction in question:

- Stage 1. Examine the formalities of filings of interest, focus on primary jurisdiction(s) and primary portions of technology, review any key licenses and permissions related to the technology.
- Stage 2. Carry out an in-depth review of file wrappers; consider whether any opinions are necessary and if so initiate searching; substantively review relevant assignments and employment contracts; expand the scope of investigations to additional filings/jurisdictions as appropriate.
- Stage 3. Prepare preliminary versions of any opinions, carry out any investigations required to go behind the documentation that has been reviewed.
- Stage 4. Expand and formalize any opinions as needed; carry out or request any remediation that may be appropriate; finalise any reporting letters that may be required.

It is important to remain in close communication with the client so they can help establish and revise priorities as the due diligence project evolves.

Time and cost parameters have to be established from the outset. Because the process evolves with each new piece of information, costs have to be estimated step by step. A reasonable figure can be determined for initial investigations, then an assessment can be made and the client can decide where it wants to focus next and how much it is willing to invest to be confident of what it is getting. Initially many clients will require only the briefest online confirmation that maintenance fees have been paid and that “on the face of it” the target has the rights it purports to be offering.

Start by determining which patent families are to be reviewed, whether the review will be limited to a subset of jurisdictions and how much reliance will be placed on materials supplied by the target company. It is worth reviewing from the outset to what extent representations and warranties may be adequate to protect the client as they may set the parameters for any due diligence that is to be conducted. While suitable contractual guarantees may be comforting, in many cases the assets involved may be so critical that contractual guarantees can never adequately protect the purchaser or licensee.

The extent of investigation that may be desirable depends on the objectives of the deal. In some cases a purchaser may have no intention of actively working the patents, and may merely want to take them out of hands of competitors. In others the client may want to exclude competitors from the market and it may be essential to examine the scope of the patent portfolio, and whether competitors will be able to readily design around any key elements of patented technology. If the target is a specific piece of technology rather than a corporate entity then the client may already have a very detailed understanding of the technology in issue and due diligence questions may be relatively specific. For a larger portfolio that covers a wider range of subject matter it is worthwhile identifying a subset of key patent families that relate to critical elements of technology, and deciding which are the most significant jurisdictions. In many transactions there are only a relatively small number of commercially important jurisdictions and clients may be satisfied to look only at the US and possibly any European or Japanese filings. If there are no immediate red flags they may take filings in the rest of the world on trust.

Within individual families and filings, it can be helpful to focus on particular sets of claims that address key elements of the technology and clearly it is simplest to start by looking only at the independent claims. It is essential to consult with the client as the due diligence proceeds, but in particular it is important that they help set the priorities for the initial stages of due diligence so that the process is made as focussed and as effective as possible.

While a patent portfolio often consists of only filings for utility patents, in some transactions industrial designs (known in the US as design patents) may be significant. Some foreign jurisdictions (for example China, Germany, Japan and Russia) have a further type of patent registration, known as a utility model. Broadly speaking a utility model may be thought of as a poor man’s patent. They are usually available only for more limited subject matter than a utility patent. For instance they may not be available to protect methods or plant and animal products. They generally have a relatively short life time which may be around six to ten years. Although their registerability requirements may, in principle, be very similar to those for utility patents, applications are often only examined for formalities. Thus they may be easy to register but equally easy to attack because of their limited preliminary examination. When it comes to enforcement, validity will inevitably be put in issue.

It is prudent to request copies of relevant materials early on, even if it is not yet clear whether it will be necessary to review them. If a vendor cannot promptly supply a decent status report, and cannot provide relevant documentation quickly and in good order, this should raise a red flag concerning the overall management of their intellectual property portfolio. It is good to have everything readily to hand so as to avoid further roadblocks when new questions arise and the due diligence schedule is suddenly accelerated. Even if the target cannot realistically supply everything required immediately, the request will get the wheels moving so that when the information really is needed, a good portion of the work of gathering it may already have been done.

#### 4. Stage one: basic on-line inquiries and brief review of documents

As indicated above, and normally contrary to legal advice, many clients will require only the most cursory due diligence before proceeding. Direct on-line verification of the existence, registered ownership and maintenance fee status of known filings in primary jurisdictions and a brief check for any corresponding foreign filings may be all the client wants (although clearly the client should always be counselled that there may be all manner of problems not revealed by such a cursory investigation). This preliminary investigation usually involves confirming (to the extent possible online) basic information provided by the vendor, identifying any immediately pending deadlines, and if budget allows then noting any registered third party interests.

If any pre-existing opinions on the target intellectual property have been made available then these should be reviewed. The costs are relatively minor and the potential benefits to the client are substantial. Some basic searching for related litigation is also advisable.

Early investigations may also comprise identifying technology that is important but is not protected by registrations, identifying key items of confidential information, important licenses and development agreements, all of which may need to be examined as due diligence proceeds. Clearly, if any of the rights in question are granted by license (either to the target or by the target to third parties) then this will need to be examined carefully, and any associated contracts should be briefly examined for obvious red flags. Due diligence is just as important for licensed IP as it is for purchased IP. But licensed rights raise additional issues of their own, such as degree of exclusivity, grant back of rights, and bundling with other technology. Similarly there may be regulatory controls that are relevant to the technology in question. Licensing issues and regulatory issues are not considered here.

If large numbers of filings are involved, then advice should be sought from the client as to which filings or families of filings, and which jurisdictions are significant so that initial work can focus on them. Likewise, where filings may contain large numbers of claims, technical advice should be sought to determine which claims are of real business significance, so that if opinions are requested then these can be properly focussed to save both time and money.

If it is clear that extensive due diligence will be conducted, then aspects of work listed in stage two, three and four may be commenced at this time.

#### 5. Stage two: looking a little closer

Initial investigations need to be evaluated and there needs to be a dialogue with the client before proceeding. The first “look see” should give a sense of whether the target IP has been generally well managed or whether there is cause for fundamental concern. Always keep in mind and remind the client that the information from the online databases may be outdated or wrong. Having seen

what the databases say, it may be desirable to go beyond this and start to look at the file wrappers and consult relevant local agents for further input. Is the status suggested on the face of the database record correct? Are there any historical errors (errors in owner or inventor names, incorrect declarations of entity status, missed or incorrectly paid fees etc.)? How easy might it be to design around any claims? Does a first review indicate any concerns regarding validity, freedom to operate, claim scope etc.? This is also a good time to decide whether any validity, patentability, or freedom to operate opinions are going to be required and on which jurisdictions these should focus. Since opinions can be very expensive, many clients will limit themselves to an opinion concerning any key US filings. Also since opinions take time to prepare, the sooner one has instructions to get started the better. Searching can be initiated while other types of investigation are underway. One may also want to consider any possible concerns that are unique to particular key jurisdictions, such as whether the patent has to be “worked” in order to remain valid, and whether the government may have exercised any overriding right to exploit the invention.

At this stage, one should also review the substance of related licenses, assignments, development and confidentiality agreements and the like in detail to confirm the scope and adequate documentation of any key relationships, permissions and prohibitions. While the details of licensing agreements are beyond the scope of this paper, issues such as limitations on transfer or sub-licensing, degree of exclusivity, territorial limitations, term and the like are among the critical issues.

Although Canada does not generally allow the content of the file wrapper to be used to construe the claims of an issued patent (known as file wrapper estoppel) others jurisdictions do consider the content of the file wrapper in court proceedings, two examples being China and the United States. A comparison of file wrappers from different jurisdictions may reveal valuable information such as prior art that was not disclosed or considered in other parallel filings, and contradictory positions that an applicant may have taken in different filings. This kind of information is all potential fodder for any future litigation.

A few specific issues should be mentioned regarding the file history of a Canadian patent application:

The duty of disclosure imposed on applicants and their agents under Canadian law has arguably been expanded by court decisions [9]. But it seems generally agreed in the profession that this duty is probably not as expansive as the ongoing duty to disclose that is recognized in the United States.

The Canadian Intellectual Property Office (CIPO) now requires that an applicant for patent provide a declaration of the basis of the applicant’s right to apply. The caselaw does not yet provide guidance on how these declarations may be treated in the future but they are usually filed separately from the petition to make inapplicable Section 53 of the *Patent Act*, R.S.C. 1985, c. P-4, which states that:

“A patent is void if any material allegation in the petition of the applicant in respect of the patent is untrue, or if the specification and drawings contain more or less than is necessary for obtaining the end for which they purport to be made, and the omission or addition is wilfully made for the purpose of misleading.”

While the legislation presents a specific format and language for the declaration, allowance is also made for this language to be modified to allow the particular circumstances to be accurately described. The declaration relates to the events occurring prior to filing, subsequent transfers of ownership have to be evidenced by assignments. Very recent caselaw [14,15] has substantially changed the extent to which a Canadian court may wish to analyse the accuracy of information contained in an application and has provided valuable guidance on possible grounds for validity challenges.

When reviewing a file wrapper remember that it may not tell the whole story, for instance registered documents may be subject to unregistered agreements with additional provisions.

## 6. Opinions

As clients become more aware of IP issues, opinions and particularly freedom to operate opinions are becoming more commonly requested. These can take a great deal of time to prepare and may require many iterations of searching to identify relevant prior art references, which can include both patent documents and other publications. As consideration of one set of references suggests new lines of inquiry, reveals new emphases, and gives the searcher an improved understanding of what technical factors are most important the scope and details of the searching may evolve and expand. The general rule of thumb for a thorough search is to stop when the same references keep coming up and nothing new is appearing. Of course, it always remains possible that another day of searching in a different database or a different language, might turn up a crucial new reference, but the line has to be drawn somewhere and in highly technical areas the technical personnel are often familiar with the latest developments and can help to limit the work needed. It should be borne in mind that relevant prior art may include prior patents and patent applications (even if no longer in force), and any other publications such as journal articles, website materials, books and the like. Sometimes prior art may provide a “safe harbour” against possible allegations of infringement of an issued patent. A good understanding of the strength of the target portfolio, as well as how this relates to the activities of any potential competitors, is critical to any transaction and there are plenty of cautionary examples of the surprises that may await those who do not invest in a thorough consideration of the competitive landscape [10]. A detailed understanding of the portfolio and of its competitive significance is important for the client to determine whether a deal should proceed at all, and to make a judgement regarding value [11,12].

The impossibility of preparing a thorough freedom to operate opinion without a good deal of time (maybe three or four months depending on the depth of searching, the number of issues that arise, and the level of certainty required) is a compelling reason to involve counsel early. The conflicting demands of speed and thoroughness also require careful prioritization. What starts as a brief and preliminary opinion in the first stage of due diligence may later have to be formalized. It is important to have a clear picture of what has already been done and why, so that earlier efforts do not have to be repeated. It is vital to develop a system to keep track of what searches have been carried out, which references have been found, and which have been deemed relevant or otherwise, and why. This is essential to allow work to be halted and restarted in response to instructions, whilst avoiding duplication of effort and wasted energy as searching and analysis proceed and the client asks for a closer look at specific aspects of the technology.

Shortcuts are always helpful, in highly technical areas the applicant may already be aware of the key references and may be happy to rely on a review of them alone. A careful review of prior filings by the same applicant and inventors can often identify significant prior art that may establish “safe harbours” from infringement concerns. There may be specific jurisdictions, inventors or entities of particular relevance. For instance, applications related to traditional Chinese medicines may be more highly represented in Asian databases. In any event, a careful debriefing of client technical personnel can help to dramatically narrow the scope of work, and technical personnel need to be intimately involved in the assessment of any apparently relevant documents that may be identified.

Preparing a freedom to operate opinion can be time consuming and expensive. The detailed legal criteria will vary depending on

applicable law so it is important to focus carefully on the key jurisdictions for the business. In practice this usually means getting an opinion on the lead filing but clients will often settle for a preliminary review which will often yield the same qualified “maybe” as a formal opinion, but in fewer pages and at lower cost. In practice, a client may opt for a preliminary legal review of infringement issues and safe harbours identified in a search before proceeding to formal opinions. In this way it may be possible to narrow the focus of any formal opinions by carefully focusing on specific references and technical features, to thereby rationalize and limit the scope of work and the consequent costs. If relevant opinions already exist then it may prove more expedient to review and update these than to go through the whole process again.

## 7. The opinion letter

While a detailed discussion of opinion letters is far beyond the scope of this paper, there are a few key qualifications that should always be included, and obviously there will be many others that are appropriate depending on the circumstances:

- A thorough and correct opinion does not guarantee that a court will come to the same conclusion as the author. This may appear self-evident but clients faced with an adverse court decision will not necessarily share this view.
- Further searching (however thorough one has been) may still reveal additional relevant references.
- Where the client’s technical expertise has been relied on, and where the client has specified the references to be considered, this should be noted.
- Unless agreed beforehand, one should specify that third parties may not rely on the opinion.
- Set out any issues that have not been considered and the potential issues that may arise.
- If the client intends to rely on the opinion in future or to use it in litigation, try to leave some room to revisit and revise claim construction if additional information comes to light. One should also endeavour to keep opinions on different aspects of a technology, or different filings, separate, so that if one has to be disclosed in discoveries, the others are not inevitably disclosed too.
- While ensuring accuracy and correctness of the opinion, try to frame the opinion in positive terms (from the client’s point of view), and if there is an additional but less welcome perspective, spell it out to the client verbally. Any written admissions of infringement, invalidity etc. may be damaging in the context of future litigation.

## 8. Stage three: going deeper

### 8.1. Behind the paper

The paper record is not always correct. For transactions that have a substantial value clients may be willing to incur the cost of more thorough investigations. This additional effort is always desirable but in many cases not financially acceptable.

Interviews with personnel may be conducted and background research carried out to confirm that all and only the true inventors have been named on applications, and that rights have been assigned or waived by all relevant parties. Interviews can also reveal whether any of the work was done by visiting scholars or others with no contractual obligation to the applicant. They may reveal financial contributions by third parties that might give them some claim to an interest in the technology. Laboratory records and interviews may reveal undisclosed prior art, and can also shed light on the

relationships between key technical personnel and the company. If there is bad blood between the inventors and the company then problems can be anticipated when it comes to obtaining signatures, replying to office actions, giving testimony in any lawsuits and the like.

## 8.2. Secondary jurisdictions and other issues

A detailed review of international aspects of technology rights is beyond the scope of this article, but there is ample guidance to be found in the existing literature [13]. Once a review has been conducted regarding one or two primary jurisdictions of interest, more attention may be focussed on additional jurisdictions. This raises a wide range of issues and a few of the more frequent ones are briefly mentioned here:

- Bad translation is a very common cause of deficiencies in corresponding filings. For key jurisdictions, it may be worthwhile to have the national filing translated back into English to determine whether the content is really as good as might be hoped.
- Check for consistency in the naming of inventors between equivalent filings, or between a PCT filing and any national equivalents and ensure that any changes in inventorship can be properly explained.
- Applicants may not have disclosed all relevant prior art in some jurisdictions. Cross check what has been disclosed in relation to different related filings.
- Some jurisdictions may have specific limitations on patentable subject matter, (for instance methods of medical treatment, stem cells and the like are not patentable in all jurisdictions) so that claims that have issued in the US (for example) may be unobtainable in other jurisdictions.
- Some jurisdictions, such as the United States and China may impose a first filing requirement or may require some form of security review before a foreign filing is made. One should confirm that these requirements have been complied with or establish the consequences of non-compliance.

## 9. Stage four: remediation and the final report

The last stage of diligence is about finalizing any analysis, and identifying and implementing any remedial measures. Workarounds and prior art that may provide a “safe harbour” to allegations of infringement of third party rights may be sought. The client may wish to consider acquiring or licensing competing applications and patents. Any desirable remedial assignments, and corrections of the official record may be prepared or requested. If new prior art has been identified, the target may be asked to address it. If problematic third party filings have been identified the target may be asked for its comments, or it may be desirable to initiate challenges or revisit the price or the terms of the transaction.

## 10. The final report

There are often a series of separate reports prepared as the project proceeds, each dealing with different aspects of the work. There are a plethora of caveats that are or may be appropriate, and no attempt is made to list them here. Any urgent deadlines should be highlighted. If there are deadlines pending in the portfolio, then the negotiations may be influenced by decisions as to which filings will be kept alive and which filings may be abandoned once the transaction is completed. Transitional provisions may be required in any contract documents to maintain the portfolio in good standing until the transaction has closed, any assignments have been registered, and the purchaser is fully and finally in control.

If there are a number of early stage filings then give the client (most likely a potential buyer) some warning about how the costs may escalate in the next few years. For instance, if the portfolio contains a number of PCT applications which will shortly have to enter the national phases, then there may be a dramatic increase in the anticipated costs in the short term. Without some warning of this, unsophisticated clients may be caught by surprise and face real difficulties when national entry deadlines arrive with their attendant costs.

## 11. Conclusions

Due diligence is inevitably a dynamic and evolving process. Many clients will not wish to incur the time and expense of a detailed due diligence review, others will go much further. Obviously the final scope of due diligence inquiries will respond to client requirements, and may focus on specific issues which become apparent as new information is uncovered. It is important to be flexible and responsive to new developments and changing priorities.

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