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# Is That Your Final Offer?

## Valuing Patent Licenses in Infringement Negotiations

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While there is no single or best method for determining the license value of a patent portfolio, certain parameters may be relied upon when negotiating an arms-length agreement – especially when a charge of infringement is included. Analyses such as those used in the courtroom are frequently seen for what they are – a construction sometimes more suited for punishment than for providing a basis to forge an agreement. In the negotiating room, creditability and understanding are essential. Overanalyzing or diving into minutia often complicates the process. Negotiated settlements do not depend on convincing a third-party (the jury) whether or not a plaintiff is grievously injured. When two antagonists look at each other across a table, they must find agreeable value systems that allow them to put the matter to rest.

There is also an attempt by some to predict licensing values through patent mining efforts. While this approach might be helpful in deciding to pursue a technology licensing program, accurately predicting the profits from an assertive licensing strategy is not likely to happen. For an aggressive program, patent mining is useful in eliminating patents that indicate no potential licensing value and highlighting patents that bear further technical investigation. For those intending to charge others with infringement, a patent becomes valuable after it has been proven to have claims with great content and craftsmanship. Until that happens, talk of potential profits is premature.

### K.I.S.S.

Two things are necessary to value a portfolio fairly in negotiated settlements: Licensing experience with the portfolio and simple models.

Experience shows that determining the value of a patent or a portfolio requires completing several licenses. Each company's portfolio has unique strengths and weaknesses and the best way to prove that is to subject it to the scrutiny of a recalcitrant licensee.

The best and easiest settlements are the ones that line business executives can intuitively grasp. Both sides – the licensee and the licensor – generally want to know the lump-sum payment amount or the royalty rate and to believe the settlement is reasonable considering the circumstances. They do not want to puzzle over "The portion of the realizable profit that should be credited to the invention . . ."[1] or "The opinion testimony of qualified experts."[1] Nor do they want to fight over gross profit margins for projected sales. The licensor and licensee want to know that if ". . .both had been reasonably and voluntarily trying to reach an agreement; . . . a licensee (such as the infringer) would have been willing to pay as a royalty and yet be able to make a reasonable profit and . . . would have been acceptable to a prudent patentee who was willing to grant a license."[1]

Elaborate models are sometimes used by licensors to impress the other side or to assuage the feeling that something important could be overlooked. However, even when one uses a simple model, the most important question begs answering: What royalty rate should you use? Rates matter. They are expressed in the same units as "gross profit margin" and "profit after tax" – something business executives understand and are prepared to deal with.

Nevertheless, when first attempting to license a portfolio, certain considerations push the rate higher or lower. Therefore, and with respect to *Georgia-Pacific,* I suggest looking at important factors that influence the level of an arms-length royalty rate negotiated under adverse conditions.

### Views across the table

#### Guilt and knowing what to do about it.

If there is a reasonable presumption of infringement, an infringer may have no choice but to take a license if a) it has significant capital invested or b) the current design is the low cost method for meeting the objective or c) the manner in which something is accomplished is necessary to meet a standard. This exerts significant upward pressure on the rate.

However, if the licensee feels the licensor does not have the backbone to litigate when necessary, all bets are off. I have seen the situation where a patent holder had not previously litigated a particular portfolio and the infringer stopped negotiating until the client filed a lawsuit against it, whereupon the parties concluded a license shortly thereafter. This can further influence the rates higher if the licensor incurs significant legal costs and unduly puts

1. *Georgia Pacific Corporation v. United States Plywood Corporation;* factors pertinent to the issue of value; 318 Federal Supplement.

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its portfolio at risk.

**Tolerance to pain.** What is the potential financial impact on the licensee? What portion of the licensees sales does the portfolio cover? Do the U.S. patents have foreign counterparts thereby expanding the pervasiveness of infringing product? How bad would an injunction banning future sales hurt the business?

The greater the impact of a potential adverse court judgment relative to the size of the infringer's business, the higher the rate a licensee will likely consider. Even for technology licensors with no litigation redress to consider, if a new technology will significantly lower costs or increase value, the licensee must consider the impact of the licensor working closely with the licensee's competitors, thereby causing significant loss in market share or profitability.

**Diamonds and cubic zirconium.** What is the demonstrated or perceived strength of the patents? Has the portfolio previously been judged valid and infringed? Even a favorable Markman ruling gives the licensor leverage in asking for a royalty rate in the upper ranges. A licensee must think long and hard before pushing into and through litigation if the construction of claims and/or previous judgments make defending against charges of infringement difficult. There are those who believe the best licensing program begins with litigating the patents – through appeals if necessary. Betting the ranch on a litigation-first strategy can bring enormous returns or it can stop a program cold before it earns anything.

Even if there has been no litigation history, just how strong are the claims of the patent? Claims that make an infringer sit up and reread them for the tenth time are better than claims for which the licensor must make tortured constructions in order to assert a license is necessary. Even without any admission of concern on the part of the potential licensee, both parties realize the rate for a great claim will be in the upper ranges. The reason for this is the infringer believes – usually correctly – that it can negotiate a better deal than will result after going to trial and losing.

**Escape routes.** Are there design-around options? Are there available acceptable alternatives? If the infringer has the ability to change the design of the product or modify the process used to create it (method patents), the rate the infringer is willing to pay falls. This is frequently offered as a defense to an offer for a license.

Such a position needs careful examination. Would making a change take a long time and divert scarce resources away from higher priority projects? Would it create an incompatibility to a standard? Even if successful, what happens to the cost of manufacturing or using the product? Finally, if there is a better way of accomplishing the same end, why is the infringer doing it this way in the first place?

The fewer the alternatives, the more justification there is for a high royalty rate.

**Use some common sense.** Patent values, while varying within an industry, vary even more broadly between industries. It is imperative the licensor understands how things get done in the industry impacted by his or her patent. Some industries favor cross-licenses without any complicating balancing payments – i.e. a zero royalty rate. If the licensor wants to shake things up, fine. Just don't be na ve. The chances for a negotiated solution are enhanced if you keep it competitive and practical.

Licensors like to think in terms of single digit rates. However, as some of us have seen in the early days of semiconductor licensing, what do you do when there are many manufacturers of DRAMS? A new start-up faces serious problems when facing low product volumes combined with a 20-50% cost disadvantage because of a dozen license agreements. As a practical matter, the start-up has no choice but to travel the litigation route, hoping to defeat some licensors, at the cost of millions of dollars. In general, the greater the number of licensors for a given set of licensees, the lower the rate affordable to any and each.

**Pay now or pay later.** Every licensor and licensee considers: "Which is better, a fully paid-up, life-of-patent, lump-sum payment or a running royalty?" From my experience, it appears that lump-sums can favor the licensee at the licensor's expense. Lump-sum settlements are all about the licensor buying down risk.

Running royalties paid over the term of an agreement expose the licensor to many uncertainties. Will the licensee go bankrupt or change its business strategy to eliminate the manufacture and/or sale of infringing products? Are the product sales estimates of the licensor's business case overly optimistic? If they are, the true effective rate of the settlement is higher than it seems during negotiations (conversely, from the licensee's view, does it expect future sales to be significantly higher than the licensor's estimates such that the effective rate of the settlement is much lower than the licensor thinks). Licensors are sometimes willing to accept a lump-sum with a lower rate to get that "bird in hand" – especially if it also means that they can avoid putting their patents at risk in a potential trial.

To both parties, running royalties represent the headache of reporting and auditing. The licensee, if faced with a number of licenses for continuing royalties, looks at another infrastructure adding to the cost per unit. Yet, for all the problems, this kind of agreement allows a sharing of risk by both parties and, for this reason, should not be dismissed summarily.

**The first in the arena don't always find the hungriest lions.** In the initial stages of a licensing program, it may be worthwhile for a licensor to give a better deal to a targeted licensee(s) – the early adopter. It can be important for the portfolio to show some pedigree. To be able to say an industry leader felt a need for a license (and paid for the privilege) can be valuable in future negotiations.

Experience has shown this can be a two-edged sword. If future licensees learn about the deal – through litigation, for example – they will try to demand the same low rate. There have been situations where through discovery the infringer received documents imputing differing rates[2] for a host of licenses granted by my client. Immediately, the infringer's expert witness opined that in the event his client lost at trial, the only fair rate would be the very lowest rate. Still, the strategy has its merits.

**Risk and reward.** What exactly is the business case for the licensing strategy? Does the licensee just want to get a deal done or is the objective to achieve fair and full value? There is always a trade-off between licensing quickly for lower rates or taking a harder line in negotiations in hopes of achieving a better result. The first alternative might be accomplished with much lower expense and/or risk. The expense and risk of negotiating hard can include litigating the patents. For first time licensors, the decision can be difficult.

**Multiple roads to fair value.** One can show value in ways other than the rate used to set a running royalty or to calculate a lump-sum payment. Is the license exclusive or nonexclusive? Is it one-way or cross? Does the license have a broad or narrow field of use – e.g. as to products or geography? Does volume matter? What releases have or have not been provided? Is there a term to the agreement or is it for life-of-patents? Are there additional business relationships between the two parties that should be considered? All these factors move a rate one way or another.

Infringers will frequently point to the actual cash payment as the indicator of value. Of course, if there is a small payment and the new licensee agrees to buy substantial product from the licensor, the value or effective rate of the agreement is much higher than it might appear. The alternatives to direct monetary compensation can be endless.

There is a special case requiring additional ingenuity in determining value – high tech start-ups. The problem is that the market is as yet undeveloped, which makes a lump-sum settlement too difficult for a small firm and a straight running royalty may create a profitability problem for the licensee. I have seen good work done by others in crafting novel alternatives including stock options. This can be an especially difficult area and deserves all the attention it can get.

**Nevertheless, not any road will do.** If you do not know where you're going, the wrong road hurts. The manner in which a negotiation is played out can have enormous impact on the settlement. Preparation, preparation, preparation. The side that knows its facts, executes a plan, and approaches the negotiation with a great deal of energy – both physical and mental – will inevitably push the rate in a direction that benefits it. Situations can arise where one side gives away more than is necessary simply to end a protracted confrontation. At the same time, the opposition should believe that while you as the licensor or licensee do not want to delay resolving the issues, you have all the time in the world to get it right and you will not rule out any options or strategies at your disposal.

Another huge barrier to settlement is any lack of professionalism by one of the parties. I believe there is no room for litigation-happy tigers unless a trial is the desired result. Fortunately, the majority of people I have dealt with argue with logic and passion and leave the overt intimidation tactics at home.

### Better left outside the door

Certain parameters come up in negotiations that should have less impact than some participants attempt to afford them.

"My portfolio is bigger than yours." *When the tip of the spear reaches the heart, the length of its shaft and the method of application are no longer important.*

When infringement occurs, the number of patents and whether you are negotiating or litigating means little compared to the threat of injunction. What matters is the number of patents a party must license in order to conduct future business. The real power behind patents is the ability to enjoin an infringer. One infringed patent can result in an injunction. So can 50. The economic value of one or 50 infringed patents doesn't change by a factor of 50.

So, what is the value of a large portfolio and/or a large number of patents asserted against an infringer? The bigger the portfolio, the increased likelihood there will be a large number of patents to assert. Asserting more patents increases the ***probability*** that at trial, the patent owner will win and the court will grant large damages and an injunction in the event the parties cannot agree on a future license. If there is only one patent for the infringer to defeat, the probability of the patent owner prevailing is some percentage. With more patents, the probability of prevailing on one or more patents is higher. At some number of patents, the marginal increase in the probability for the patent owner prevailing on at least one patent grows smaller. Therefore, the increase in value of a large portfolio (hundreds or thousands) over a small number of patents (a few to hundreds) is minimal – given the same field of use.

The above is tempered somewhat by factors beyond the value of the current negotiation. In a negotiated agreement, the parties frequently desire protection and patent peace. The licensee does not want exposure to future litigation on other patents in the portfolio. Therefore, a larger portfolio may afford some collateral benefits.

**"I can't afford it."** Nowhere in patent law does it say that an infringer who is losing money on products that infringe another party's patent is immune to paying a royalty to the patent holder. The infringer's options are to change, get out of the business or pay up.

2. Rates are imputed when lump-sum settlements combine past damages with future licenses that are based on estimated sales.

There is, however, a legitimate issue here. As noted above, the licensor needs to keep it competitive and practical. Profitability goes to the heart of whether it is worth it to the infringer to continue in the business. It may serve the licensor's interest to raise barriers to others. If the objective is maximizing royalties, a licensing strategy must sustain a strong royalty base.

**"It is my investment dollars that developed the technology."** This issue parallels the profit argument. It does not matter what R&D or development costs the patent holder shouldered. It does matter what the costs will be for the infringer to design around the infringed claims. So, as with profitability, the licensor needs to keep this in mind – just not as a directed argument in the negotiating room.

## Conclusion

The real value of a patent portfolio is that which is revealed in a set of negotiated or court-awarded settlements. It is not something computed a priori. Researchers who tell CEOs the potential income stream of a licensing program before they have experts evaluate patent claims and before they gain experience in the negotiating room – with said patents or similar patents in the same product markets – are likely to be wildly wrong. In either direction.

In the meantime, as shown, there are factors that should be considered when beginning the licensing program. These factors tell a lot about a program's potential. Just don't bet the business's five-year plan on the results.