A Negotiator's View
Of Patent Portfolio Values
In Negotiated Licenses

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A Negotiator's View Of Patent Portfolio Values In Negotiated Licenses

While there is no "best" method for setting the license value of a patent portfolio, certain parameters should be considered when negotiating an arms-length agreement. Over-analyzing or immersing oneself in the minutia of mathematics will complicate the process. The licensee generally wants to know the lump-sum payment amount or the royalty rate and to believe the settlement is reasonable considering the circumstances.

Elaborate models are often for the benefit of the licensor to assuage the feeling that something important was overlooked. Simple models are valuable but they do not answer the key question: What royalty rate should you use? Experience shows that determining a reasonable rate requires completing several licenses for a particular portfolio of patents. More analysis does not solve the problem. Therefore, with all due respect to *Georgia-Pacific*, I suggest looking at ten practical factors that can influence the level of a negotiated royalty rate.

WHAT TO CONSIDER

1. Currently infringed – or not. The stick or the carrot question. A licensor may be licensing new patents that represent a technological advance and capture the interest of a product or service provider. This is often referred to as technology licensing. Because the licensee is not currently infringing and may have no serious interest in switching to something new, the licensee may place a low value on the portfolio.

Conversely, if there is a presumption of infringement an infringer may have no choice but to take a license if it has significant capital invested or the current design is the low cost method for meeting the objective or the manner in which something is being done 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 client had not previously litigated a particular portfolio and the infringer stopped negotiating until my client filed a lawsuit against it, whereupon a license was concluded shortly thereafter.

2. Potential impact on licensee. What portion of the licensee's 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 consider.

3. 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. The 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 more 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 explain why 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 usually believes that it can negotiate a better deal than will result after going to trial and losing.

4. Design-around options. 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. Frequently, this is offered as a defense. Such a position needs to be carefully examined. Would changing take a long time and divert scarce resources away from higher priority projects? Even if successful, what happens to the cost of manufacturing or using the product? If there is a better way of accomplishing the same end, why is an infringer doing it this way in the first place? The fewer the design or modification alternatives, the more justification there is for a high royalty rate.

5. Industry rate norms and licensing breadth. There is certainly variability in rates from one industry to another. Not surprisingly, rates within a single industry can be unpredictable. In the case of differing industries, past IP practices and breadth of patenting are important. So are the sales base and profitability. Some industries favor cross-licenses without any complicating balancing payments – i.e. zero rate.

Within an industry, you have aggressive, litigation-happy tigers and courteous, gentlemen-like negotiators. You have the small volume infringer and the industry leader. It is not hard to guess who pays or receives the higher rates.

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 startup 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 startup 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, the lower the rate.

6. Lump-sum payment vs. running royalties. 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 sale of infringing products? Are the product sales estimates of the licensor's business case optimistic thereby artificially deflating the model's rate for a suggested lump-sum settlement (conversely, from the licensee's view, does it expect future sales to be significantly higher than the licensor estimates such that the true effective rate of the settlement is much lower than the licensor thinks)?

Licensors are willing to accept (in many cases, rightfully so) a lower settlement 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.

7. Early adopters. 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). It can be important for the portfolio to show some pedigree. To be able to say that one of the industry leaders felt a need for a license – and pay for the privilege to boot – 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. Still, the strategy is not a bad one.

8. Licensor's strategy. There is always a tradeoff between licensing quickly for lower rates or lump-sum settlements and taking a harder line in negotiations in hopes of achieving a better financial result. The first alternative is usually 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.

9. Contractual terms and conditions. Value is shown in ways other than the rate used to set a running royalty or calculate a lump-sum payment. Is the license one-way or cross? What releases have or have not been provided? Is the license exclusive or non-exclusive? Is there a term to the agreement or is it for life-of-patents? What other non-monetary compensation is included in the agreement? All these factors move a rate one way or another.

10. Conduct. The manner in which the 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 stamina 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.

OVERBLOWN FACTORS

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

1. Portfolio size. The argument is often heard that "my portfolio is larger than yours." The only thing that matters is the number of patents a party must be licensed to in order to conduct future business. The true 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 is roughly the same.

The benefit of more patents is increasing the likelihood that at trial the patent owner will win and the court grants an injunction. 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 <u>one or more patents</u> 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.

Admittedly, aside from the license being negotiated, there can be an exception to the value of large portfolios. In a negotiated settlement, the parties normally desire protection and patent peace. The licensee does not want exposure to future litigation on other patents in the portfolio. Therefore, a larger portfolio can afford some collateral benefits.

2. <u>Profits</u>. 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. Profitability to goes to the heart of whether it is worth it to the infringer to continue in the business. The revenue derived from the infringing product determines royalty amounts.

3. <u>R&D or development costs</u>. This issue parallels the profit argument. It does not matter what costs the patent holder shouldered. It does matter what the costs will be for the infringer to design around the infringed claims.

<u>CONCLUSION</u>

The 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. Today's patent mining efforts are rightfully limited to eliminating patents that indicate no potential licensing value and to highlighting patents that bear further investigation – like critically reading claims for content and craftsmanship. Researchers that 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.