Ten rules for choosing a non-practising entity

The universe of non-practising entities has grown dramatically over the past 10 years; companies with quality patents to monetise should consider 10 key factors when choosing which to work with

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The top 20 corporate investors in R&D deployed US$142 billion on sales of US$1.6 trillion in 2011. Surprisingly, this huge investment did not directly translate into product innovation, higher margins, enhanced competitive positioning or market share. For example, the productivity of pharmaceutical company R&D remains below 10%, and Google, Apple and Amazon did not even make the list.

What this huge spend did create was intellectual property, as illustrated by the relentless increase in patent filings in all jurisdictions. The World Intellectual Property Organisation records almost 1 million patents filed since 1985. However, these are expensive for inventors to file, maintain and prosecute.

In seeking returns on their sunk (and usually expensed) IP spend, multinationals are increasingly looking to monetise their patent portfolios. This activity is big business. Patent monetisation through licensing results in over US$500 billion of revenues in the United States each year, while in the last 12 months alone notable patent sales have exceeded US$30 billion.

The specific reasons for a patent monetisation effort may vary, but typically include the following:

- Companies may wish to offset the costs of their IP protection efforts by harvesting licensing fees.
- Core business areas are often overprotected. Monetising excess core patents generates income that is pure profit.
- Changes in corporate strategy, restructuring or M&A activity create 'orphan IP'. This no longer has operating value and so monetisation is an obvious strategy.
- The patent assets of distressed companies may be worth more than the company's market capitalisation itself (eg, Kodak, Adaptix or Nortel).
- The value of key patents may underpin financing. One way to validate valuation is to monetise all or part of the portfolio.

In each of these cases the most straightforward route to patent monetisation is to sell the assets. However, many trade buyers are likely to be competitors, and while there have been some notable patent sales recently (eg, the US$4.5 billion sale of Nortel patents to the Rockstar consortium), the notion of an active industry participant selling its patent trove to a competitor is counterintuitive. The pharmaceutical industry is an exception in this regard, where the percentage of new drugs derived from in-licensed patents ranged from 13% (Merck) to 100% (Baxter) between 1989 and 2004, with an industry average of over 50%.

If a straightforward patent sale is rejected as a monetisation option, the next choice for a company is to generate income via assertion-based licensing or enforcement using either in-house staff or external parties. In the absence of an approved pool, the choice turns to in-house enforcement, with the business and reputational risks of countersuit, or via a non-practising entity (NPE) – sometimes referred to as a patent troll.

The universe of NPEs has grown

dramatically over the past 10 years, with the success of incumbents, intense industry competitiveness highlighting the strategic value of patent assets and rising infringement awards. For example, Acacia Technology (a NASDAQ-listed NPE) has seen its market capitalisation grow to almost US$2 billion during that time. Consequently, companies with quality patents to monetise now have a choice of NPEs to work with. In determining the best fit for a particular transaction, there are 10 key factors to consider.

Understand market positioning

NPEs vary by size, quality and depth of staff, corporate culture, business model, investment horizon and risk appetite. An NPE may specialise in a particular technology area (eg, semiconductors) or have particular expertise in dealing with blue-chip companies or geographic regions (eg, Asia). An NPE may have a strong track record in US litigation or Asian licensing, or be more of a hybrid NPE/strategic adviser/private equity investor. The market positioning of a particular NPE is a reflection of its origin, legacy and *modus operandi*. Ideally, when selecting an NPE, a company should meet more than one and find a group which has a specialism and culture that is aligned with the company's objectives. Failing to do this can have some significant negative side effects, including failure to monetise, reputational/brand damage and tainting of other intellectual property.

Be comfortable with the monetisation strategy

Most patent licensing and assertion conversations are settled out of court and the quantum of damages/royalties claimed often drives the appropriate strategy for an NPE.

Where the NPE believes that it has a wide universe of counterparties to approach, its policy may be to file a modest settlement claim with each potential infringer and start the clock ticking. Its hope in this strategy is that the settlement amount is so far below the cost of defending litigation that the aggregate out-of-court settlement generates a significant sum. Multiple aggressive parallel lawsuits, contingent legal support and a great deal of publicity are used to create negative PR to pressure a settlement. This is a 'scorched earth' approach.

An alternative approach, which can be characterised as 'conference room litigation', relies on the NPE validating its claim through rigorous industry and technical analysis, providing the infringer with a compelling business case for significant accrued royalty payments. Typically, this approach takes longer to prepare and is more costly in terms of due diligence. It often involves fewer, more significant participants and is focused on getting the infringer to settle based on the quality and strength of the claim for amounts that tend to be two to three times larger. The threat of litigation is there, but as a last resort.

For a company considering which NPE to select, the choice of strategy depends on the IP portfolio itself, market conditions and appetite for reputational risk.

Be clear on targets

Many companies do not wish an NPE to litigate against their customers, suppliers or other potential strategic partners. However, a NPE is motivated by the straightforward desire to monetise to the fullest extent the patents that it acquires. To address this problem, the seller may wish to provide the NPE with only a limited list of targets (a so-called 'white list'). There is no guarantee that the NPE will respect this list and often the seller may try to enforce restrictive covenants around its intellectual property or retain conferrable licences that allow it to protect strategic counterparties. Hewlett-Packard was one company noted for this approach. Obviously, any limitation in terms of applicability for a patent portfolio reduces its value and, more importantly, may result in a denial of enforcement in the United States, as noted in the recent International Trade Commission enforcement action between Apple and HTC.

Critically assess the NPE's value proposition

Each NPE has its own value proposition. For example, Acacia Technologies is vocal in its belief that a long operating history and broad-based IP portfolio provide it with a unique edge. Its belief is that its experience curve of execution – specifically, its knowledge of how certain infringers will react – combined with the

richness of prior art data that it has accumulated over time gives it an edge. A reverse argument, however, favours a specialist NPE with a specific technical focus (eg, process patents) or legal jurisdiction expertise (eg, Germany or Korea). In determining which approach to take, a company should understand which factors are most relevant to the niche product/market in question (eg, whether relationships with the infringer are critical or whether other factors, such as size and resources, weigh more heavily in securing the desired result).

Seek a deal to maximise revenue generation

The 'tradable value' of patent portfolios approximates to 5% of their predicted assertion value. Notwithstanding this rule, certain patent and technology portfolios, such as those of Motorola Mobility or Nortel, have generated sale prices far in excess of expected tradable values. This illustrates a simple point: an asset is worth what someone is prepared to pay for it, particularly when it has strategic value for the buyer. It has also led to a trend of patent inflation as patent owners benchmark against market prices.

The bid/offer gap between what a company believes its patents are worth and what an NPE is willing to pay has rarely been wider. One way to address this mismatch is to agree profit share arrangements between the company and the NPE. Workable arrangements recognise the need for an NPE to generate a base case internal rate of return of between 25% and 30%. The company's profit share kicks in beyond the base case and is often capped at a number that reflects an equitable sharing of risk and reward. The *quid pro quo* for this type of risk sharing may be that the company is required to compromise on the white list (increasing the market value of the asset) or provide access to internal corporate resources during enforcement actions, such as emails or inventors.

The impact for the company of reaching the right economic arrangement can be meaningful. For example, on a portfolio with assertion value of US$250 million, the revenue outcome for the company may change from US$12.5 million (5%) upfront to over US$100 million over time. Back-end profit share arrangements vary greatly and exact deal terms are a function of the financial health of the company, the size, brand quality and technical strength of the portfolio and the negotiating skills of the participants.

Understand the NPE's model

NPE business models include defensive licensing (eg, RPX), patent litigation (eg, Acacia Technologies) and outsourced licensing as a service (eg, Mosaid). Other companies that acquire and assert third-party patents may be operating companies (eg, GE's former licensing and trading division) or unique business models, such as Intellectual Ventures. Given this diversity, the selection process for companies can be a complex one and is often driven by a confluence of factors. These may include:

- Personal relationships with key people.
- Revenue targets.
- Time horizon.
- Market impact.
- Wider strategic business relationships with infringers.

Alcatel-Lucent's decision to shift its entire IP portfolio to RPX in May 2012 is a good case study to evaluate in this respect. The decision to outsource may limit or preclude litigation since RPX statutes forbid it.

Understand the NPE's investor base

An NPE has shareholders. The risk appetite and industry norms of these investors will influence the manner in which the NPE interacts with companies and how they attempt to monetise an IP portfolio.

There are three primary types of NPE:

- Those structured as public companies (eg, RPX, Acacia).
- Those backed by a hedge fund or high-net-worth individuals (eg, IP.com, ACP).
- Those backed by private institutional investors (eg, Intellectual Ventures).

The cost of capital for each of these investor types is different, with hedge fund/high-net-worth investors typically requiring the highest returns. Private equity investors may be concerned about a chilling effect on future investments or fear countersuits on their portfolio companies. Concern about reputational risks may be a feature also for limited partnerships which

prefer not to invest in aggressive actions.

The philosophical position of a particular NPE will manifest itself in its initial due diligence requirements, time to market, tendency to prefer upfront versus back-end economics, optionality of returns (eg, seller put option), willingness to participate in an auction or to accept any restrictive covenants or requirement for vendor finance.

Beware 'Frankenstein's monster' syndrome

If the economics are attractive, an NPE may exit a portfolio it has purchased through a trade sale, putting valuable patents into the hands of a competitor.

Typically, sellers seek to retain a perpetual licence for any intellectual property that they sell to an NPE, but these may not be comprehensive and an unintended outcome may be that a company becomes the target of a lawsuit for an unrelated/unforeseen application at a later date.

Restrictive covenants may be effective to mitigate this risk or alternative strategies, which avoid a sale, may be of value to companies when an IP portfolio has significant strategic value for others.

Contemplate 'schmuck' insurance

The executive who sells intellectual property to an NPE and then finds out that it is the foundation for a new class of consumer product will have a short-lived career. One way for IP managers to protect themselves and avoid becoming a 'schmuck' is to retain a call option on the asset above a certain value or after an agreed time period. There are risks with this approach (the sale looks like a lease), but an NPE may welcome such an arrangement if it is paired with some form of downside protection. In effect, the economics are collared in much the same way as securities transactions are routinely executed. This is more prevalent in pharmaceutical licensing discussions or IP acquisitions with private equity firms (which are satisfied with a three to five times return and see this as a valuable risk mitigation technique).

Understand the value of auctions versus relationships

An NPE will always seek to buy a patent portfolio below its fair market value. This investment strategy is well established, having been first formulated by Benjamin Graham in *The Intelligent Investor* in 1949. In this context, the valuation of intellectual property is as much an art as a science. The NPE is always at an information disadvantage compared to the company and, as a result, seeks to offset this by reducing its upfront payments, extending payment terms, capping profit shares or lowering overall assertion value estimates.

A company will often consider an auction as one approach to obtain the best price for its patent assets. This may generate high upfront payments or potentially spoil the asset's marketability if interest is low. It is important to understand that interest in an auction may be driven by external factors unrelated to the quality of the asset (eg, recent NPE fund raising success or propensity to compete on initial price) and thus an auction creates a selection bias among bidders. Moreover, patent assets bought in auction may force a more aggressive enforcement strategy to meet internal rate of return targets, which can be an unintended consequence for the seller.

Conclusion

The decision to monetise intellectual property via an NPE is a strategic one that augments a company's in-house licensing capability. The decision to select a particular NPE should therefore be taken in the context of corporate strategy, revenue objectives and ongoing relationships with potential infringers.

A sustainable model for a company to achieve consistent success in its NPE interactions is to build a network of key NPE relationships. This approach provides insight into the strengths and weaknesses of each NPE and allows a 'horses for courses' strategy to be adopted on a transactional basis. In normal circumstances, NPEs operate in a supply-constrained market; an ongoing strategic dialogue is therefore of great mutual benefit to both parties. iam

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