Fighting enterprise-level IP risk

Although IP ownership can be hugely beneficial, it does bring with it risks of certain downsides, from assertions by patent trolls through to potential shareholder suits. A recent survey suggests that certain types of insurance could help to mitigate such risks

By **Nir Kossovsky**

"What will you say when they ask what happened?" So goes a rhetorical demand in a white paper from the intellectual asset arm of a leading risk management consultancy. Helpfully, the white paper suggests that executives who would like to identify, quantify and manage their IP risks in a better way should begin by asking questions.

The Intangible Asset Finance Society, comprising executives in the finance, risk, security, safety, intellectual property and corporate governance disciplines, asked questions during the autumn that has just gone. In September 2006, the Society invited the intellectual asset community to participate in a survey with the teaser: "In IP rich companies, who bears the ultimate risk in IP litigation, IP M&A or technology transfer – shareholders, outside counsel's E&O insurance, the company's law department, the company's D&O insurance or professional IP risk bearers?" This article reports how the community responded.

Intangible assets, intellectual properties and risk

Intangible assets comprise both the creative products and perceptions of the mind. The products include the arts and sciences – inventions, music, literature and other creative works that improve the quality of life. The perceptions include intangibles such as quality and safety (read: brand). The values in products are covered by patents and copyrights; the values in perceptions are covered by trademarks.

Under the spotlight of the post 9/11, FAS 133, 141 and 142 world of increased transparency, Sarbanes-Oxley and the Terrorism Risk Insurance Act (TRIA), executives and directors have an explicit duty to measure, manage and protect their company's intangible assets. Good intangible asset management means maximising return on assets (ROA). Good intangible asset protection means ensuring those assets remain present, or if lost, are replicated, rebuilt or replaced.

The Intangible Asset Finance Society was formed to promote good intangible asset management practices. The Society sponsors events that provide education, advocacy and the promulgation of standards for the purpose of enhancing the overall value of this asset class. In October 2006, in cooperation with *IAM* magazine, the Society held a symposium on intellectual asset risk-linked securities.

In advance of that event, the Society conducted a survey comprising intellectual property risk scenarios. The scenarios, based on recent events, looked at capital market consequences of patent ownership disputes and what the respondents felt would be ideal risk transfer strategies. The three scenarios were:

- Patent assertion by Freedom Wireless against Boston Communications Group (NASDAQ: BCGI) (a patent troll v traded company example).
- Patent assertion by Tivo Inc (NASDAQ: TIVO) against Echostar Communications Corp (NASDAQ: DISH) (a corporate assertion between two traded companies).
- In-licensing of patented technology platform from Fujitsu by Sun Microsystems.

Demographics of respondents

From among those surveyed, there were 114

***IAM* magazine is the official organ of the Intangible Asset Finance Society (www.iafinance.org)**. In each issue, *IAM* publishes a contribution from the Society on a topical intangible asset finance matter.

respondents representing a cross section of corporate executives, outside (non-legal) consultants and outside (legal) counsel. They reported having broad experience in intellectual property-related litigation, licensing and M&A activity. One-third responded anonymously (Figures 1, 2).

Equity markets are sensitive to IP litigation

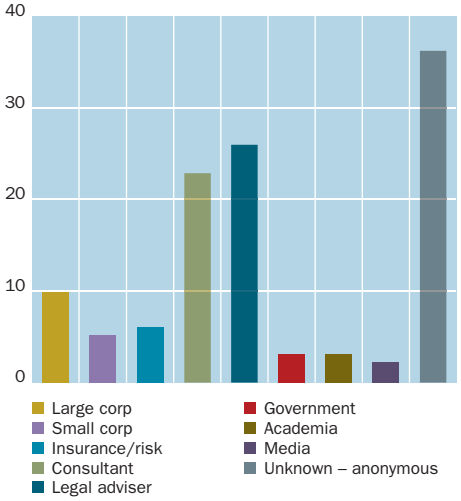
Patent litigation is risky. In a company where margins are supported by patented technology, or where the freedom to operate is protected by patents, the loss of patent protection may have enterprise-wide consequences. The Society hypothesised that enterprise-wide consequences would manifest as a drop in market capitalisation or a reduction in credit strength.

With respect to market capitalisation, respondents felt that the equity markets would recognise an increase in enterprise risk arising from patent litigation: 75% felt that the equity markets would respond with a fall in the stock price of a traded targeted company in the setting of a troll assertion (Figure 3); while 68% felt that a stock price drop would accompany a dispute between and among two traded companies (Figure 4). When asked about the impact of insurance, only 41% of the respondents felt that the stock price would still drop in the setting of troll-driven litigation (Figures 5); while 46% felt that there would be equity market consequences in a dispute among two traded companies (Figure 6). The expected ability of insurance to mitigate the risk of an adverse movement of equity value in response to the litigation was statistically significant among the respondents with a $p<.001$.

Credit markets are less sensitive to IP litigation

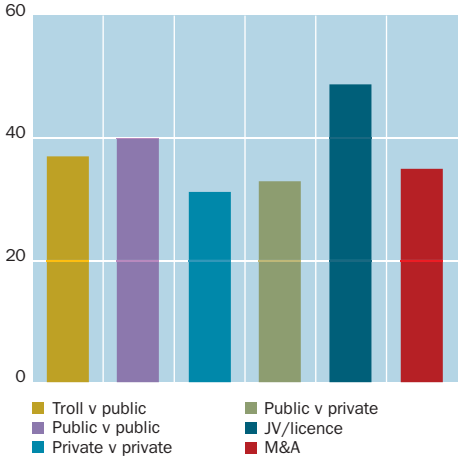
In connection with the same two troll and traded companies assertion scenarios, 34% opined that the targeted company's credit terms would harden in the case of the troll assertion, while only 19% felt that credit terms would harden in the case of the duel between two traded companies. In the presence of insurances, the proportion that felt credit terms would still harden dropped to 11% and 9% respectively. The expected benefit of insurances on the credit markets was statistically significant with a $p<.001$.

Figure 1



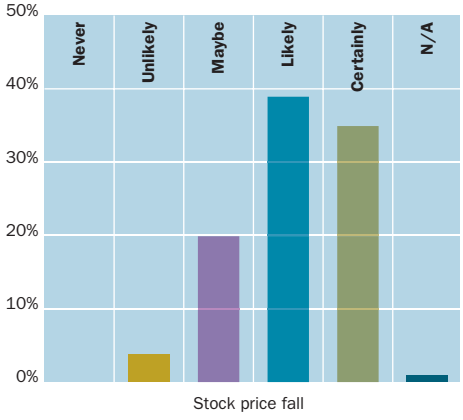
The professional backgrounds of the respondents

Figure 2



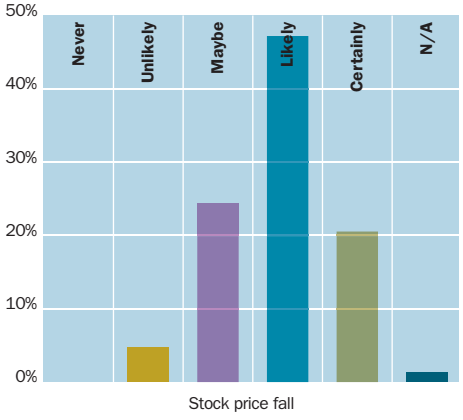
The respondents reported a significant level of litigation and transactional experience. Nearly 40% had been involved in patent assertion litigation by a professional assertion company against a traded company, assertion litigation among two traded companies, litigation between two traded companies and mergers & acquisitions. Nearly half had been involved in IP licensing

Figure 3



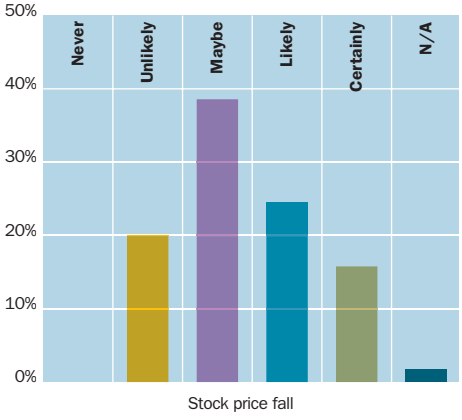
75% of the respondents opined that an assertion by a professional patent assertion firm (troll) would trigger a fall in the price of the targeted company's stock price

Figure 4



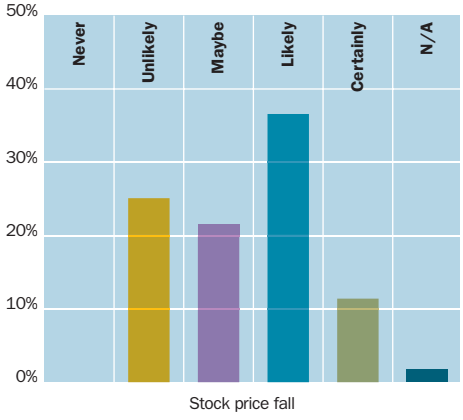
68% of the respondents opined that a patent dispute between two traded companies would trigger a fall in the price of the targeted company's stock price

Figure 5



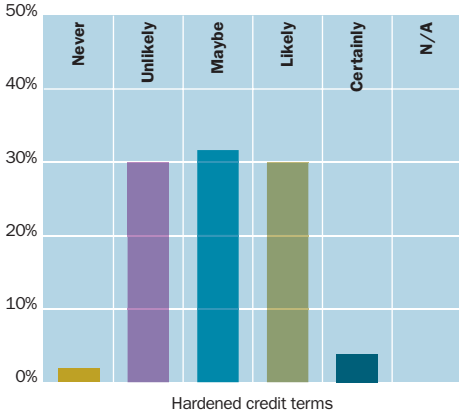
About half of the respondents who opined that an assertion by a professional patent assertion firm (troll) would trigger a fall in the price of the targeted company's stock (Figure 3) felt that insurances could mitigate the equity market risk

Figure 6



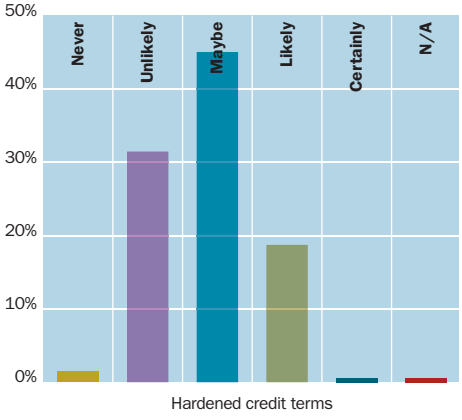
About one-third of the respondents who opined that an assertion by a public company against another public company would trigger a fall in the price of the targeted company's stock (Figure 4) felt that insurances could mitigate the equity market risk

Figure 7



34% of the respondents opined that an assertion by a professional patent assertion firm (troll) would trigger a hardening of the targeted company's credit terms

Figure 8



19% of the respondents opined that a patent dispute between two public companies would trigger a hardening in the targeted company's credit terms

Risk transfer can embolden an asserter

One of the traditional forms of defence in patent litigation is a countersuit. In a dispute between two patent-rich companies, each can assert and, in turn, can be asserted against. Each thus places its own patent estate at risk in litigation with an equally matched firm and this fact creates an aura of mutually assured destruction (MAD) that tends to dampen the fervour for litigation. The introduction of the professional assertion company, which has no portfolio to defend because it produces no product, destabilises the MAD environment. The IAFS hypothesised that insurances would transform a public

company into a troll-like entity by mitigating countersuit risk.

In connection with the public company v public company assertion scenarios, 46% agreed that an insured asserting public company was a more formidable adversary. Upon closer look, the stratified data show meaningful patterns. Among corporate executives, only 30% agreed with the hypothesis; 43% of the non-legal consultants agreed and 52% of outside counsel agreed. Conversely, as a group 28% disagreed. Among corporate executives, 30% disagreed; 22% of financial consultants disagreed, and 39% of outside counsel disagreed. Last, 40% of corporate executives had no opinion, 35% of financial consultants had no opinion and only 9% of outside counsel had no opinion (Figure 11a and b).

Licensing (and m&a) risk

"Proudly found elsewhere" has been popularised by one patent-rich consumer products company as the knowledge economy's retort to "Not invented here". Technology in-licensing is a well-recognised strategy for mitigating a panoply of R&D risks. But what about the downside?

Technology in-licensing and strategic corporate acquisition driven by a desire to obtain intangible assets comprising a patent portfolio, and perhaps management, scientists, engineers or brands, is not without risks. In a scenario featuring a public company licensing a new platform technology from another public company, the Society hypothesised that the in-licensing firm was assuming maximum enterprise risk – colloquially, "betting the farm".

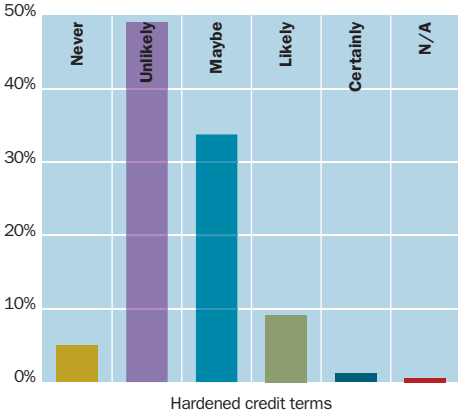
As a group, 68% of the respondents agreed. Taking a stratified view, 80% of corporate executives agreed, 78% of consultants agreed and 58% of outside attorneys agreed. In short, there was near unanimity (Figure 12).

Risk transfer through insurances

It is said that the insurance industry as we know it today began in 1666 after the Great Fire of London destroyed four-fifths of that city's buildings and nearly two-thirds of its wealth. In an effort to protect his own property as well as to stimulate the rebuilding of London, Dr Nicholas Barbon, a wealthy physician and economist, founded the modern world's first commercial insurance establishment.

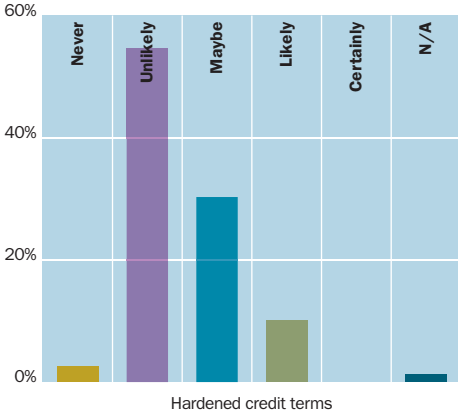
The Society is interested in protecting the value of intellectual properties in order to reduce capital market volatility and further

Figure 9



About two-thirds of the respondents who opined that an assertion by a professional patent assertion firm (troll) against a public company would trigger a hardening of the targeted company's credit terms (Figure 7) felt that insurances could mitigate the credit market risk

Figure 10



More than half of the respondents who opined that an assertion by a public company against another public company would trigger a hardening of the targeted company's credit terms (Figure 8) felt that insurances could mitigate the credit market risk

Figure 11a

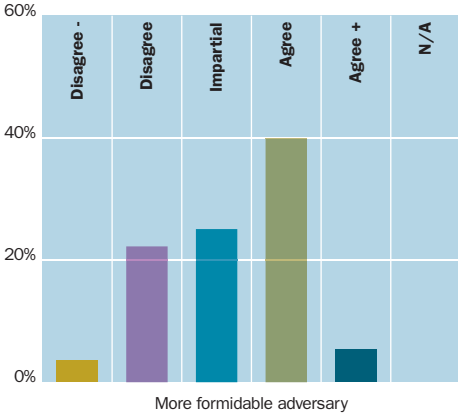
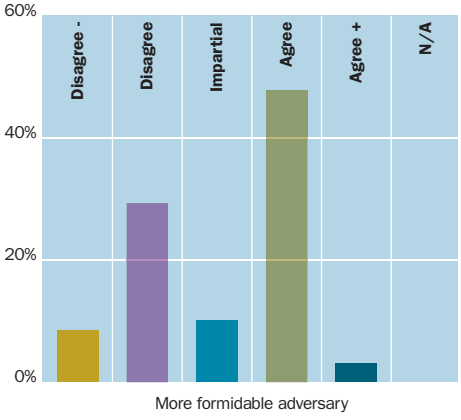


Figure 11b



Among outside counsel (11b), it is a split decision with 52% agreeing, 39% disagreeing, and almost no one left standing without an opinion; among all the respondents as a group (11a), 46% agreed that an asserting public company is empowered by insurances and can therefore be more "troll"-like, while nearly 25% had no opinion

Figure 12a

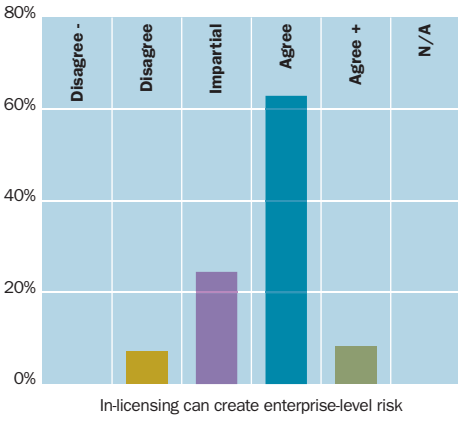
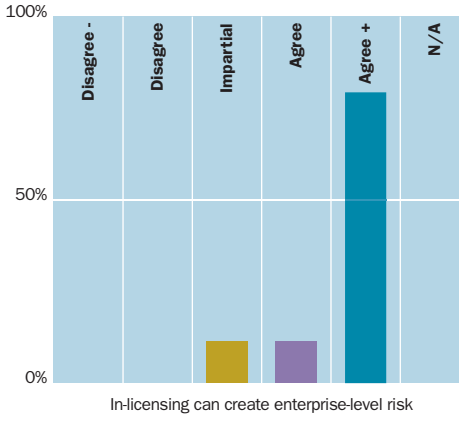


Figure 12b



The respondents on the whole (12a) agreed that a public company was assuming substantial enterprise-level risk by in-licensing a platform technology. Corporate respondents, as a group, showed the highest concurrence level. Eighty per cent agreed that in-licensing could present substantial enterprise level risks

Figure 13a

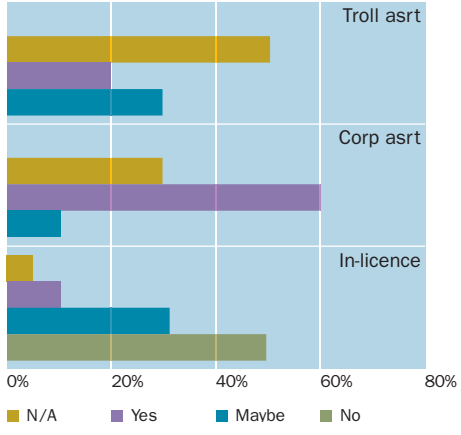
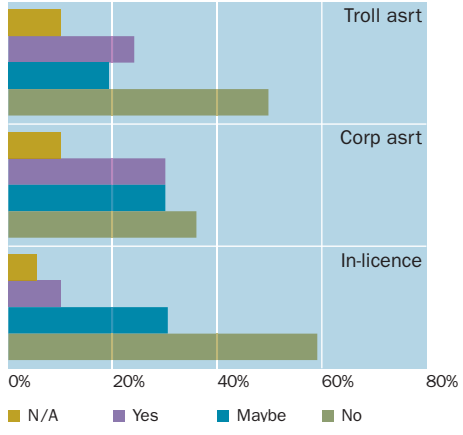


Figure 13b



The respondents had differing views on the potential value of business interruption insurances for patent-related causes. As a group, 40% felt such insurances would be useful in the setting of troll litigation; 30% felt it would be useful in the setting of corporate assertion; and 20% felt it would be useful even in the setting of a platform in-licence scenario. Corporate respondents, on the whole, were favourably disposed or uncertain (13a); outside counsel, on the other hand, had stronger negative opinions (13b)

stimulate the growth of a knowledge economy. While the Society is not establishing an insurance company, the Society is interested in identifying the best financial solutions to intangible asset challenges and codifying them as best management practices.

The Society hypothesised that certain insurances might be valued by the intellectual property community. The three were:

- Business interruption due to patent loss.
- Patent litigation costs.
- Shareholder litigation arising from IP-associated directors' or officers' liability.

Business interruption (injunction) risk insurance

In the context of the three risk scenarios, 40% felt that protection from business interruption in the setting of "troll" litigation could be a valuable risk transfer solution; only about 25% felt that in-licensing (or M&A) created enterprise-level risks that would benefit from injunction risk insurances. In the context of troll assertion, a stratified view showed interesting differences. Consultants and corporate executives favoured insurances. Almost 50% of each group felt that insurances for business interruption triggered by troll litigation were potentially worthwhile; but only 20% of outside counsel concurred. On the other hand, about one-third of each of the three groups agreed that business interruption insurances for corporate v corporate litigation could be a useful risk transfer solution (Figure 13).

When asked to place a value on the business interruption insurances, consultants were most generous with the premium levels they were willing to pay (or have their clients, the corporations, pay), while corporate executives were the least generous (Figure 14a and b). On the whole, respondents felt that 1% rate on line (US$1 dollar premium per year for US$100 dollars of protection) was appropriate, but there was a wide range among all three groups.

Patent litigation cost risk insurance

The perceived value of insurances to cover patent litigation costs varied significantly among the three groups. Forty per cent of outside counsel responding felt that insurances for patent litigation were worthwhile whether the setting was troll litigation, corporate v corporate litigation or a dispute arising from a licence. Twenty per cent of the corporate executives held the same view. Consultants' views varied depending on the setting of the

Figure 14a

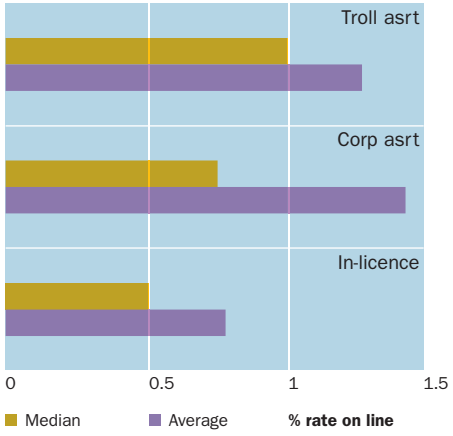
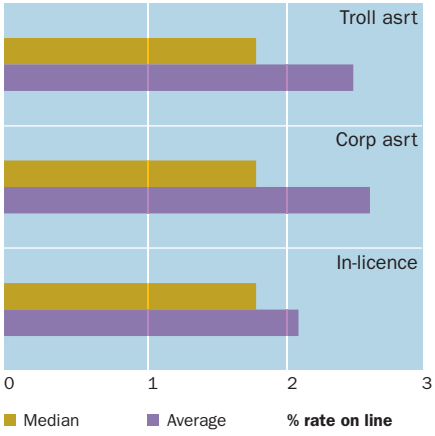


Figure 14b



The respondents had differing views on the pricing of business interruption insurances for patent-related causes but centred on about 1% rate on line ($1 premium for $100 dollars coverage). For business interruption triggered by patent injunction arising from an in-license or acquisition, consultants (14b) felt that 1%-2% rate on line was appropriate, while outside counsel and corporate executives (14a) felt that 0.5%-1% was more appropriate

Figure 15a

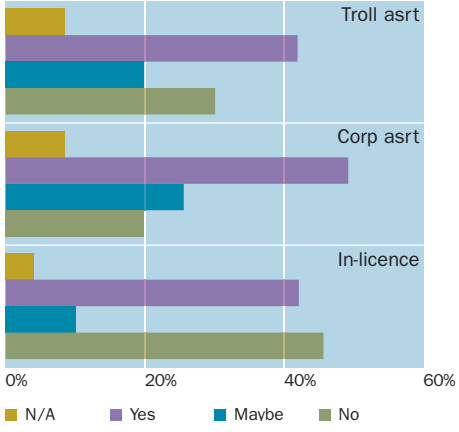
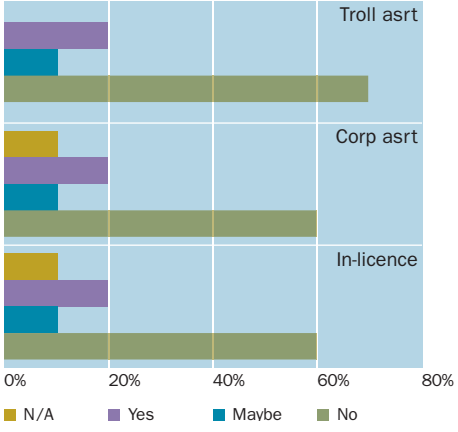
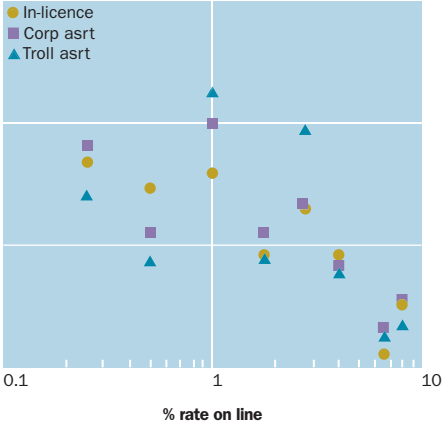


Figure 15b



While the respondents as a whole were relatively enthusiastic about insurances for covering the costs of patent litigation, outside counsel (15a) and consultants were most bullish; most corporate executives responded that they were not willing to insure the costs of patent litigation (15b)

Figure 16



The respondents had differing views on the pricing of patent litigation insurances but centred on about 1% rate on line ($1 premium for $100 dollars coverage). Consultants felt that 1%-2% rate on line was appropriate, while outside counsel felt that 1.5%-2.5% rate on line was more appropriate. Corporate executives weighed in at nearly a full order of magnitude less with price values of 0.25%-0.6%

litigation: nearly 60% felt insurances were worthwhile for troll litigation, less than 50% felt they were valuable for corporate-led litigation and less than 30% saw value in licensing-triggered litigation (Figure 15).

As to pricing, there was almost an order of magnitude difference between the ideal price of patent litigation insurances among outside counsel and the ideal price of patent litigation insurances among corporate executives (Figure 16).

Shareholder litigation risk insurance (patent-triggered D&O insurance)

Last, as a group, there was a greater willingness to insure against shareholder litigation arising from a troll-initiated patent dispute than for the other two scenarios. Nearly half of the respondents felt that such insurances would be valuable. Consultants and outside counsel were most supportive of these coverages; only 20% of corporate executives thought they would be worthwhile

Figure 17a

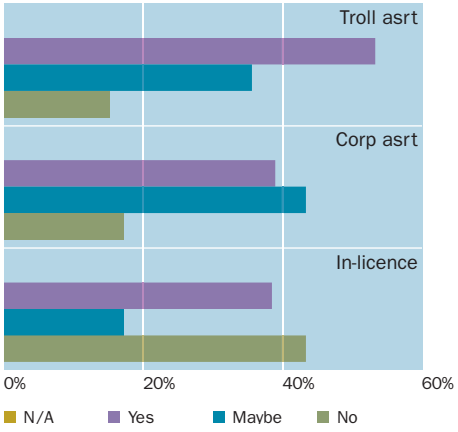
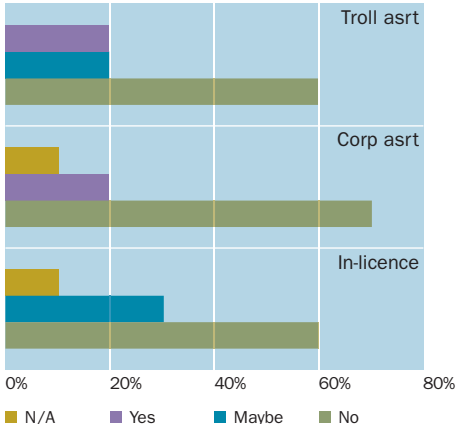
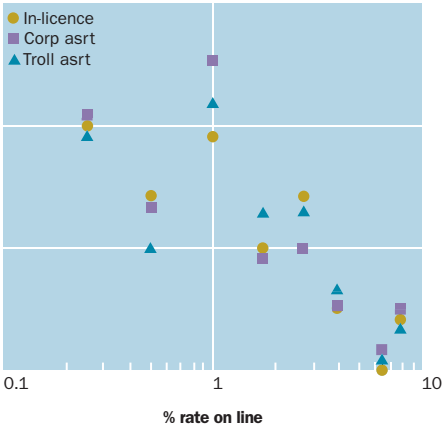


Figure 17b



Among outside counsel and consultants (17a), 30%-40% of the respondents felt that insurances for shareholder litigation arising from any of the three IP scenarios would be worthwhile; corporate executives (17b) were decidedly less enthusiastic with 60% or more responding that they would not be willing to insure against the costs of shareholder litigation

Figure 18



The respondents generally concurred on pricing for insurances covering shareholder litigation arising from any of the three IP scenarios. However, consultants were willing to pay a little more at 1%-2% rate on line, and corporate executives were willing to pay a little less at 0.5% rate on line. Outside counsel split the difference

(Figure 17). Corporate executives were even less enthusiastic about insurances for shareholder litigation arising from corporate-initiated patent disputes or from complications of a licence or M&A transaction.

Pricing, as with the other insurance scenarios, centred about 1% rate on line. Consultants were least price sensitive at 1%-2%; outside counsel felt that 1%-1.5% was about right and corporate executives were the most conservative at around 0.5% rate on line (Figure 18). As a reality check, D&O insurances today are priced at between 2.5% and 3.5% rate on line for public companies and 1% rate on line for private companies.

Mixed picture

The 114 respondents, representing a cross-section of corporate executives, outside consultants, outside counsel and others, agreed that the above examples comprised material enterprise-level risks that might be addressable through insurances. Seventy-five per cent of the respondents felt that if their company or client were involved in a troll assertion situation similar to Freedom/BCGI, their stock price would fall; and in a corporate assertion situation similar to TiVO/Echostar, 68% felt their stock price would fall. In the presence of insurances, the expectations of an adverse equity event dropped to 41% and 45% respectively. Similarly, the respondents saw credit hardening as a risk. Thirty-four per cent felt the former scenario would lead to adverse credit events while only 20% felt the latter would. However, in the presence of insurances, the expectation of adverse credit events dropped to 10% for both scenarios.

In addition to passive protection, 46% of the respondents felt that insurances would give a patent asserter such as TiVo a strategic advantage.

In what is often considered the mundane world of licensing, corporate executives and outside counsel demonstrated differing levels of perceived risk. In considering the third scenario, 80% of the corporate respondents agreed that in-licensing platform technologies was a 'bet the company' proposition. Only 58% of outside attorneys felt the same way.

When asked directly if they would personally recommend insurances, 20% to 30% said they would to insure against business interruption, 30% to 40% would insure against shareholder litigation from IP issues and 40% would to insure against the costs of patent litigation.

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