Reinventing The Deal

The time has come to start recognizing intellectual property as a value driver in M&A

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Keith Bergelt
Open Invention Network

Kenneth Cho
Altitude Capital Partners

Joseph Cote
Cote Associates

Steven Frank
Goodwin Procter

John Hall
Intellectual Ventures

Michael Lasinsky
Ocean Tomo

Ron Laurie
Inflexion Point Strategy

Bryan Lord
AmberWave

Is it time to start recognizing intellectual property as a value driver in M&A? Top pros in the IP field think so.

Photographs by Alanfil

Acquirers typically think about intellectual property during the due diligence phase of an acquisition, when the focus is on the underlying risk of a potential deal. There's a growing community of buyers and deal pros, however, that has started to think about IP at the outset of a transaction — as part of the evaluation of the opportunity set. *Mergers & Acquisitions,* in August, sat down with a number of IP pros to discuss the latest trends impacting the market, and the overwhelming consensus was that both buyers and sellers are failing to capitalize on the full value of IP. But a shift is occurring, and dealmakers, increasingly are beginning to realize the kind of opportunity IP presents.

Present for the discussion were **Michael Lasinsky**, a managing director at IP-focused boutique **Ocean Tomo**, who runs the firm's valuation practice; **Ron Laurie**, a former Skadden Arps attorney who founded M&A advisory **Inflexion Point Strategy**; **Joseph Cote**, who worked in licensing for GTE Laboratories, Rockwell Scientific and Arthur D. Little Enterprises before forming his own shop, **Cote Associates**; **Bryan Lord**, who heads finance and licensing at MIT spinout **AmberWave Systems**; **Steven Frank**, a partner at **Goodwin Procter**, working in the law firm's IP practice; **Keith Bergelt**, who heads the defensive patent pool for the Linux-focused **Open Invention Network** and formerly headed IP-leaning hedge funds Paradox Capital and IPI; **John Hall**, vice president of acquisitions, with patent-focused PE firm **Intellectual Ventures**; and **Kenneth Cho**, a partner and managing director at IP-centric private equity shop **Altitude Capital Partners**, where he focuses on strategic alliances and serves as chief patent counsel at the firm.

M&A: *To a lot of outsiders, the IP world probably still appears a bit like the Wild West. Seemingly every week there's a new landmark case or law that pros in the space have to deal with. As a jumping off point, I was hoping we might be able to talk about some of these issues and where the market stands today. For instance, are IP rights stronger than perhaps five years ago, and what kind of impact does that have when it comes to placing a value on a patent or trademark? Also, what are some the cases that have had the biggest impact?*

Hall: In recent years there is a lot more attention being paid to intellectual property and IP-related issues, certainly in the press. To me, it just seemed inevitable, as the strength of the US economy shifted from being a manufacturing-based marketplace to more of an idea-centric economy. When that happens, it inevitably gives rise to intellectual property rights and that inevitably brings in the lawyers, the court system and a lot of the publicity.

Much of the publicity has been around a relatively small number of cases that have produced some outsized results. I don't think that represents the bulk of what IP is. Those cases are the outliers, but it's what gets everybody's attention. The courts clearly are shifting their focus in this direction because they have to. You have seen certain courts, such as in Texas, Wisconsin and other jurisdictions, that have made a conscious decision to become more knowledgeable about IP, and that has attracted more cases, which, in turn, has attracted more press.

We will probably see that continue for a while because we are at the beginning of a rapidly growing marketplace, and over the next five to 10 years we are going to see it explode in terms of size and attention.

Cote: I started in IP about 20 years ago, and about five years ago I noticed a transition from a focus on business development and licensing to now a litigation-based intellectual property system. You can probably go back further than that. The Polaroid/Kodak lawsuit [that Polaroid won in 1985] forced Kodak to take

all of those cameras off of the market. It was a billion dollar development that created a lot of press. You also have the recent cases, such as NTP/ RIM, which have only brought more awareness.

Hall: Obviously, you can't ignore what is going on in the courts, but if you focus exclusively on that side of it, you are going to miss the bigger picture in the IP

“ Ten years ago, there weren't any companies out there to buy intellectual property.
Michael Lasinsky
Ocean Tomo ”

space. Take a look at what Altitude or Ocean Tomo are doing, for example, and they're not spending a whole lot of their time in the courts.

Lord: On the very early side of enterprise formation, the venture capitalists are recognizing an increased role of intellectual property. In years past, venture capitalists would check the box that essentially says: "Does the business plan have the associated patents?" If so, that helps reduce the risk.

Today, the VCs see intellectual property far more strategically. This is evidenced by the National Venture Capital Association being one of the parties that chimed in very strongly in the recent patent reform battle on the Hill. So now you have early stage innovators, companies like ourselves, the VCs and the universities, who all believe that intellectual property, in a flattening world, is a differentiator and one of the reasons to get behind a particular business plan.

Laurie: The fact that bigger companies are seeing themselves as targets reflects a couple of different trends in the way IP has been perceived in business circles — not only on the investment side but also on the production side. People are more willing to see IP as a strategic asset as opposed to being a lock on the door. These people are more willing to entertain notions of licensing, sharing and partnering, via an IP vehicle, as opposed to just accumulating IP as a way to keep the enemy out.

Bergelt: The fact that we have had this collapse in the financial services marketplace over the last 15 months has actually created more opportunity for money to flow. If you look at the companies and firms represented in this room, there is a significant amount of capital that has been amassed to acquire and invest in intellectual property and IP business models. These esoteric assets become fungible once they become knowable, which happens when there is some ability to assess them and place a value on them.

When you lend against an asset, for example, you take it in the default situation, and then you can monetize it, and that helps to establish a model. When you acquire an asset or you partner with someone to leverage an asset, you try to model a return either through litigation or licensing or some combination thereof that helps to validate the assets. And so we're seeing intangible assets crossing the line toward becoming knowable.

And to John's point, most of the value that is being created in the new economy is driven by intangible-assets. But along with that, there are dysfunctional components that we have inherited.

It was about three to five years ago when we started seeing a phase shift, in which the banks started to think about IP because they didn't have any other assets to lend against. Their traditional models wouldn't allow them to participate anymore, so they started to look at IP as collateral. You also had hedge funds emerge in the late nineties that started viewing intangible assets as having core value.

You're also seeing shareholders push for companies to mark these assets to market, and to show a return for R&D dollars spent. It's in the annual reports, where companies have to show what kind of return they're getting. And I would argue that it is far too low. It should start to spike as people become more concerned about how public companies are utilizing their assets.

M&A: *You talked about lending against these assets. The deal that comes to my mind is the Dunkin Donuts transaction, which is hardly a tech or pharmaceutical company. Are you seeing other areas, which you wouldn't normally consider to be IP-centric sectors, try to get their arms around intellectual property?*

Bergelt: It goes beyond patents, clearly. It encompasses trademarks and copyrights. You have to think about all of it as IP. The majority of the deals I've worked on

have been dedicated purely to trademarks.

People are recognizing the value of IP broadly. Patents are a portion of that, obviously, and since there are public and private auctions centered around IP, there is more capital, so we are, in essence, still creating a market. It's interesting to watch how it's bubbling up. You are starting to see that next to PP&E (plant, property and equipment), AR (accounts receivable) and inventory, intellectual property is emerging as a fourth vertical for asset-based lenders.

Lasinsky: A lot of it just comes back to the fact that there is capital and deals, and those deals are out there and publicly available. Companies can look at the investment, and even if it didn't turn out as expected, they can sell the assets because there are people willing to buy them. Ten years ago, there weren't any companies out there to buy intellectual property. They might have acquired the tangible assets and assumed control of the intellectual property that came along with that, but now they're buying the IP, and the tangible assets are tethered to that. The shift is huge.

Bergelt: The interesting thing is that it's not just the capital, but it's the people — it's the competence and expertise being applied to the capital.

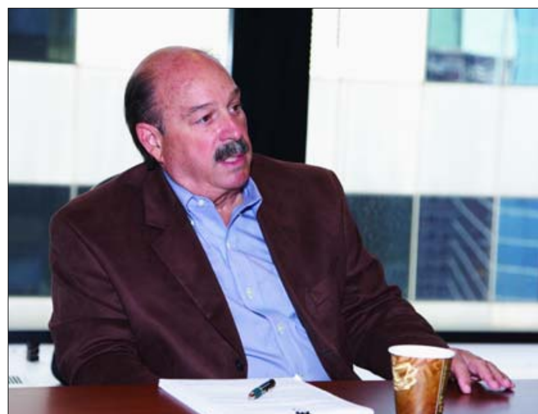
Lasinsky: Getting back to the earlier question about patent reform, what some of the courts are doing is forcing this expertise by requiring that companies really understand the patents that they control, and really know that the IP is sound and valid. It's no longer about some guy just taking a patent that they thought up in their garage and sending out a bunch of letters. That is not the model that the people in this room are interested in developing. It's about certain types of intellectual property, IP that is unique and different and nobody can get around it — those are the kind of assets that people are going to invest in; it's where the market is going.

Laurie: Broadly speaking, intellectual property is very context sensitive, and it really depends on the business model. Essentially, it comes down to why you are acquiring the specific IP. You have acquisitions for assertion, which tend to be centered on patents. There is also the defensive acquisition, which is to protect against so-called non-practicing entities. There is the strategic acquisition, which can give an operating company leverage against a rival. Finally, there is the acquisition for purposes of enhancing corporate value, which you see a lot of in the private equity world. The semantics are important, because it makes a difference whether you are speaking about IP broadly or patents, copyrights, trade secrets, et cetera.

M&A: *To take a step back for just a bit, what are your thoughts about the current patent reform bill, which is currently stalled in the Senate? Does it hit the mark? Is it far off of it? Or do you think it will even get passed?*

Hall: If you look at where the bill originated in the House, I think even they acknowledged that it was a flawed bill that was passed. It was their expectation that they would send it along to the Senate and the Senate could fix the flaws. But a lot of this is caught up in the current election cycle. There are frankly, bigger fish to fry than patent reform.

Having said that, it is something that will have to be addressed. I don't know if it will be addressed before the general election, but here you have two major candidates, in both parties, saying that patents are an important issue. At the same time, it is complicated. Unless the lawmakers really immerse themselves into it, it will be really difficult to find the right solution. There are dramatically different points of view, so it will probably depend which side gets the Senate's ear, I suppose.



Frank: The question is whether or not there is even a problem that requires a drastic legislative solution in the first place. If you look at where the motivation for this legislation originated, there were a number of academics, who — if not cynically then idealistically — thought, "Gosh, there are a lot of crazy patents out there, so something must be wrong. And if something is wrong, then we, as academics, are going to suggest a fix." That created a certain amount of momentum. You also have these larger companies that saw themselves as frequent targets of IP lawsuits. They jumped on the

> "One of the last areas to discover IP value is the M&A world, and, specifically, the traditional investment banker community."
> Ron Laurie
> Inflexion Point Strategy

bandwagon and viewed this as an opportunity to protect themselves.

The question I have always wondered about is whether or not anyone has actually delivered empirical evidence to suggest there is even a problem that needs to be solved. The patent office gets 450,000 patent applications a year — a number that is rising. Naturally, it is a human process, so there will be some clinkers that slip out the other end of the pipe. But do you really need to take a legislative hacksaw to the machinery in order to fix what might be a completely illusory problem?

The system, in my experience, has actually worked very well. There were far fewer egregious examples of problems than there were satisfactory conclusions to situations in which innovation sought protection and ultimately received it.

Some of the provisions, though, are relatively harmless and have been tossed around for a number of years. For example, whether we should be a "first to file" country or a "first to invest" country is one of the areas they're looking at. My personal opinion is that being a "first to file" country is pretty harmless in these days of low-cost provisional patent applications. But, when you start tinkering with patent damages and getting into post-grant opposition proceedings that start to look more like litigation than prosecution, it brings us more into the European model, where a lot of patents

"They'll throw a suit on a target, which will soften them up to the point that a sale starts to look more appealing."
Joseph Cote
Cote Associates

are, essentially, thwarted just through repeated delays in these proceedings. This is when I become a lot more skeptical.

Laurie: To paraphrase an old saying, "From your lips to Congress' ears."

Lord: The time for patent reform in Congress has passed. The genesis for it preceded the eBay Decision and came at a time, five-plus years ago, when we had a different landscape. We talked about how the intellectual property sophistication has changed in recent years, and there was a push, as Steve rightly characterizes, to take advantage of some circumstances whose time has come and gone.

Hall: An analogy that I have heard before is that the whole IP regulatory environment is like a noisy machine. But is the machine noisy because it wasn't designed properly in the first place, or is it noisy because it just needs some grease? I think the McCain camp came out and said that the USPTO (US Patent and Trademark Office) just needs additional funding, and that goes in the direction of what you are suggesting.

There is not a fundamental flaw with the system. It's just that, given the growth in the IP system over the last five years, the system is struggling to keep up. If you just inject some more grease into it, it will start to operate more smoothly again.

But there are some fundamental issues. Do they require dramatic legislative effort to fix? I don't know. I am not smart enough to opine on that. But there are fundamental issues, and it would be great if you could get a good patent out of the patent office in a timely fashion.

Frank: Unusual, too.

Hall: It would be very unusual, but it would be a great outcome.

Bergelt: Irrespective of what happens, whether there is legislative reform or there isn't, legislation is always about compromise. So you are going to get a solution that will take you only so far down the road on any of the big issues.

What I think, if we step up 20,000 feet and look at it, is that there is a fundamental shift afoot in the way that innovations develop. Look at these guys who are investing off of the reservation in technology development, compared to any model that we have seen before. There isn't any large scale innovation occurring that's not being done in a think tank or at a private equity firm. There are other models like that; other ways of inventing. And open source is something that is a pervasive modality change in terms of how we innovate. It really is about the democratization of innovation. It's not confined to capitalists in the G-8 countries. What it does is provide attachment points for the best and the brightest around the world.

In that kind of environment, I am not so sure that we are going to have as patent-centric a future as we have

had in the recent past. Activities like defensive publications may have more of a role in creating a patent-free environment, in which only truly innovative, truly substantial inventions ultimately get granted and make it through the patent application process.

Hall: Keith brings up an interesting point. The market is building momentum. I remember a couple of years ago when Ocean Tomo first suggested that they were going to have public auctions of patents. There were a handful of big companies I remember speaking to and they were laughing out loud about what a ridiculous idea it was. Well, those companies are now selling patents through the auction.

You see what Keith is doing with his Open Invention Network; you see what Altitude has been doing. We are all doing more and more, in spite of the fact that the regulators are trying to figure out what the right fix is. And that is just going to accelerate over time. If you think about it in a historical context, it has always been the way that things have unfolded. Regulators rarely, if ever, create market opportunities. Market opportunities get created and then the powers that be chase it to regulate it. And that's what we are seeing here.

Laurie: There is an interesting tension between the way the business community views intellectual property and patents and the way the public, generally, and the Supreme Court view the patent system. There is this tremendous momentum that John talks about where you see capital attempting to exploit this new asset class. At the same time, there is this big PR problem, which is this perception that the US patent system is fundamentally broken.

I was at the Supreme Court hearing for [Teleflex Inc. vs.] KSR Inc. Inflexion Point was on an amicus brief with AmberWave and Ocean Tomo. It was called the "Investors Brief," and unfortunately, it was on the losing side. The point is when you sat there in the same room as the nine justices, you realized that most, if not all of them, believe that the patent system is totally broken. They don't know how to fix it, but they are going to create enough chaos and confusion because they think somebody else will fix it, namely, Congress.

Lord: That's right. And there is this ironic circumstance going on in the presidential elections, where it appears that swing votes are going to come from the Rust Belt. America is searching for an answer to how we will compete in a global economy. Most people say it is going to be our innovation that will keep us ahead of the commoditization taking place in the rest of the world. And what else but patents actually can protect the innovative activity that is expected to take the Rust Belt into the next century?

At the same time, there is this concern that patents have got some sort of fatal flaw associated with them.

M&A: *That's a perfect segue to another point I wanted to raise about how globalization has altered the discussion. Because even if we do have a strong foundation for IP rights here, does it matter if China is going to take a particular technology and just pirate it?*

> "Intellectual property is emerging as a fourth vertical for asset-based lenders."
> Keith Bergelt
> Open Invention Network

Laurie: Let me just introduce that topic with one comment: and that is I don't necessarily think China is going to copy our products and run with them. It's equally likely that China is going to start out-inventing us and patenting their own products. At the time when we are dismantling our patent system, they are building theirs.

Lord: That's an even bigger threat, absolutely.

Cote: But it is still a problem. In this morning's paper, there was a story about how the golf ball industry is dealing with counterfeit imports coming in from China. They all make their golf balls locally around New England, but then they see their balls appearing on eBay and Craigslist that are coming from China. It's not really a patent issue as much as it is a trademark issue, but [the International Chamber of Commerce estimates] that there's a $600 billion counterfeit market [annually].

Bergelt: The watch industry is another one.

Cote: Everything, I mean, sunglasses, handbags, anything like that.

Hall: So you asked how globalization is changing the discussion. If you look at a firm like Intellectual Ventures, we are a small firm. We don't think of ourselves as a US domiciled firm; we think of ourselves as playing on a global surface. We're playing in Europe, North America and Asia. And we are doing that not because we fancy ourselves globalists, but because we are doing it out of necessity; we have to.

"Do you really need to take a legislative hacksaw to the machinery in order to fix what might be a completely illusory problem?"
Steven Frank
Goodwin Procter

And, Ron, I think you are absolutely right. The bigger problem is not China stealing our IP and then manufacturing it for less. In fact, if you look at what is going on in China right now, they are actually losing their competitive advantage as a manufacturing center because of rising commodity prices and rising wages. They are worried about everything leaving China and going to India.

Cote: We talk about patent reform, and do everything we can here, but if the rest of the world doesn't pay attention to the laws they have on their books, it's tough.

Hall: The irony is that as much as we are focused on what's wrong with the US patent system, the rest of the world is looking at it as a model. Granted, there are fixes that have to come into play. But we are still the example, and a lot of countries are trying to emulate what we are doing. You have got some — hopefully temporary — problems in China. You have a national government that wants to do one thing and a number of regional governments there that are doing their own thing. But China, in my mind, is where the United States was a hundred years ago in terms of government development. They are going to get here. They are going to get to where we are, God help them.

Laurie: And they typically move a lot faster than we do.

Hall: We have certainly seen that in the last 10 to 20 years. I mean, it's just amazing what China has been able to do. But I don't think the issue is China or anyone else stealing our IP. The issue is that as these boundaries start to fade more and more, how do you establish a system that works around the world and works for everybody?

Lasinsky: Our first job is to figure out the value of the patents in China. How important are they going to be? When are they going to be important in Korea and all the other countries we have mentioned? The company or investor who figures that out is going to be the winner. Because sooner or later — and it's going to be a lot sooner — you are going to be able to enforce your patents in each of the different countries, and the company that does that will end up on the top of this whole game.

M&A: *Let me ask, between John McCain and Barack Obama is there a more obvious advocate for IP? Both are talking about it, which I would assume is a good sign.*

Lord: It's way too early to tell. At this stage what you have, for the first time I know of, is that both presidential candidates recognize and include in their general technology platform a discussion about the role of intellectual property. That's a landmark event in this industry that it even shows up on the radar screen.

The issues that played out in Congress over the last couple of sessions are very technical, very nuanced, and have not risen to a level yet where you will see presidential candidates take a firm stand. If they're not going to take a firm stand on most other issues, they certainly won't touch one that divides the technology sectors in the way that the debate does right now. We have not seen either candidate suggest that somehow patents are bad, which is encouraging. We have seen, I think, a consistent recognition that it deserves attention and that IP is an area to be focused on as part of the country's innovation policy.

Hall: It is a landmark development that they even mentioned intellectual property in one of their comments. But let's face it, this isn't necessarily about who's the best candidate; it's about who has the better PR machine, and right now there are bigger and better PR targets out there.

M&A: *This seems like a good point to discuss the deal-side of the equation. A logical place to start might be how IP is valued. It's obviously not as simple as assessing a piece*

of equipment or real estate; so what goes into evaluating IP and assigning a value to it?

Lasinsky: You're right about the difficulty and I think that's why most deal people hate intellectual property. They love it as part of their transaction, but they hate trying to perform the due diligence on it and trying to value it, because you can't just look at a book and see what it sold for last time.

You have to look at a few critical areas: does anyone need to use that particular piece of intellectual property, or would they really want to use it? Is it truly unique compared to everything else that's out there? An investor in a company would want to know if the IP assets would let them own that space.

You also fall back on traditional valuation methods, asking whether or not you can design around it or how much the last piece of IP sold for? Also, how much income can you make off of products that really embody the IP out in the marketplace?

We have alluded to this, but you're seeing the market become more liquid. You're seeing more transactions, more acquisitions, more sales. Licensing deals aren't as secret as they used to be. And there are all kinds of companies that are now tracking it, trying to figure out competitive licensing terms. So the marketplace is becoming more open, which makes evaluations easier.

Laurie: One of the last areas to discover IP value is the M&A world, and, specifically, the traditional investment banker community. All these banks have patent lawyers, but the job of the patent lawyer is to protect the various models that those companies come up with. And patent lawyers, essentially, never get involved in the deals.

My experience at Skadden, over many years and almost $50 billion worth of transactions, was that the investment bankers go out of their way to avoid talking about IP and patents, especially during the valuation stage.

There are two reasons they do this, the first being that they don't truly understand IP. The second, more importantly, is that the investment bank only gets paid if the deal closes. They are smart enough to know better than to introduce into a negotiation an issue that will create a price gap. And there is no issue in the world as good as IP to create a price gap. The seller always thinks it's worth more than it is, and the buyer always thinks it's worth less. The result is that they just ignore it, which works fine for the acquirers because they get it for nothing, but the targets end up losing a substantial part of their corporate value.

Frank: And there are other reasons for that inertia. The longer the track record a company has in the market, the more difficult it is for people on the valuation side, particularly in a late-stage buyout play or in an M&A play. Has the company gotten sued? No. Well, that's good. Is that because it has a strong protective IP wall or is it just because nobody else has an IP position that they care to assert? The further along a company is in its life cycle, the easier it is to take your eye off of the IP and just look at it as an operating company independent of the IP assets it controls.

Bergelt: As the shift is occurring, which we have talked about, I think there is a greater realization of value, and an understanding of where that value lies. It's particularly acute in companies that don't have a lot of hard assets, because then acquirers have to ask, "What are you really buying?" What it comes down to is that you are buying the intangible asset.

We did a transaction for Betsey Johnson last year in which we provided a $56 million loan, $50 million of which was collateralized against her trademarks. It was a very easy transaction because you have a significant amount of licensing that comes from royalty income. When you have royalty income, it makes your job that much easier because then you can say, "Okay, I can put together a discounted cash flow model and I can come up with a number."

The replacement cost and the market valuation approach is extremely difficult. But the relief from the royalty approach is that you look at what it will be and what the royalty rate would be for the particular products. You can also look at the natural extensions of products beyond what is licensed.

> "Regulators rarely, if ever, create market opportunities. Market opportunities get created and then the regulators, if you will, chase it to regulate it."
> John Hall
> Intellectual Ventures

Securitizations, I think, helped raise the profile within the financial services community about intellectual property. On the other hand, you have to be mindful that it's almost irrelevant. Securitizations are about cash flow. The underlying asset is almost irrelevant. So you think about all of these securitization deals, like Dunkin Donuts, they're about the cash flow and the sustainability thereof, and whether or not you can model it and rate it.

Lasinsky: Five to seven years ago, you couldn't do this. At that time, if there were IP issues on the table, it meant there was a lawsuit coming or you just couldn't gain access to IP as a startup company, which meant that those deals weren't going to happen.

In the past, maybe you wouldn't be able to figure out a way to get those deals to happen. Now, though, there will be some analysis done on the intellectual property and maybe you can close that gap. Maybe the IP has some revenue associated with it, licensing income, or maybe you can expect a litigation outcome, whatever.

I am starting to see, too, situations in which people will say, "Alright, even if it doesn't have revenue associated with it, we are going to lend against this or we are going to buy into this, and we will pay for it." It's not just going to come along for free. And that's just starting to happen right now. Maybe it's because there are companies that will buy non-income producing intellectual property. Or maybe it's because the option is out there, which is allowing some price discovery. Who knows? But it's at the point now where since we can sell it, we can place a value on it, and the markets, I think, are going to move even more dramatically in that direction.

"I don't think there is any preset business model."
Kenneth Cho
Altitude Capital Partners

Bergelt: You always had this shadowy secondary market where IP assets were bought and sold, but now you have a true secondary market that is fledgling, but still exists.

Laurie: I would like to give a short war story about the deal that changed my professional career. Intertrust Technologies was a casualty of the Internet bubble. They lost all of their employees. They never had a product. All they had was an absolutely fantastic patent portfolio and a lawsuit against Microsoft. So they came to us at Skadden to sell their company.

So we went out and started talking to investment bankers and they asked, "What is the Ebitda?" We explained that there was no Ebitda. "Well, what is the revenue?" We'd tell them that there is no revenue. And after about twenty minutes of this, they finally looked at us and said, "You mean all this company has is intellectual property?"

We said, "That's right," and their response was that they didn't know what to do with it. And long story, short, we found a smaller bank that eventually took it on. The company was ultimately sold to a joint venture of Philips and Sony, who wanted to take on Microsoft in the DRM arena. Sony wanted to make a transaction platform for the Playstation 3 and that's exactly what Microsoft wanted to do with the XBox 360. Sony and Philips paid a half billion dollars for the assets, which were just patents and a lawsuit, and a year later the lawsuit with Microsoft was settled for a half billion dollars. They basically broke even.

There aren't a lot of these types of deals that come along, but that opened my eyes to the fact that, in the right circumstances, you really can wrap M&A around IP.

M&A: *That's interesting. But it also seems to bring up a concept that you hear a lot of critics talk about, and that's the idea that there are these "patent trolls" who collect IP solely for litigation. Are there any general thoughts on this?*

Cote: Well, how do you define a patent troll? Are you being attacked? If so, then you'll call the attacker a troll. I was with a firm that was called a patent troll. And it might have been accurate because they were a non-producing entity, and they merely acquired technologies for assertion potential. But that same definition probably applies to every university. It can be a hard thing to understand, but it can have a big impact since it makes for easy sound bites.

Bergelt: I would start by saying that there are a lot of

IP aggregators out there today. People are aggregating IP because there is capital available, and they are applying business models to it to drive a return—it just depends on how you implement a business model.

Ultimately, it comes back to the derivative issue of: should all those assets be out there in the marketplace? Have too many patents been granted, and are all of the patents as strong as they should be?

Well, the system has a way of squeezing out spurious lawsuits and bleeding out the players who can't develop a return. They lose access to capital. But I think we are in the early- to mid-phase of a period in which people are looking for ways to characterize their strategies, but their entities and business models have been around for a long time.

It is a difficult thing to just throw out the term patent troll. Typically, though, digest magazines like to do that because it captures a lot of attention. You have to look at the underlying business and the fact that capital is there and patents are there and people are applying business models to both of them.

Frank: The fact that we are talking about patent trolls reflects an increase in the ability to monetize IP assets. Previously, people would just view IP as kind of a stodgy set of assets that you might keep around like a holstered pistol in case you were threatened. You would never really recognize anybody's ability to use patents as a tool for monetization, as opposed to a protection mechanism. And what that really means is that there is more capital available for patent aggregation or there is just a greater industrial appetite for patent assertion.

And, by the way, somebody might be a practicing entity, but the patent that it asserts might not be in the primary focus of commercialization. So is that company a partial troll? If it's in the marketplace at all, does that absolve it of that label?

People also complain about the so-called patent thicket, in which companies can't find their way into the marketplace because there are too many patents. To the extent that we're talking about patent trolls, these "trolls" are looking for monetization opportunities. It is pretty rare that they would actually stand in the way of seeing a technology exploited—they wouldn't make any money.

Bergelt: It's important that we look to the derivative issue of how patents are created and granted. And we do have to understand the system if we are going to put ourselves in a position in which people are acquiring patents that should have never been granted in the first place because there has been prior art out there.

Typically, the average examiner has a very short time frame, I think it's around six or eight hours to review a patent. It is not a lot of time. And I think the amount of rigor in their process is really a concern. And whether it is because of the training, or the process is broken, we have created a machine that creates capital for the government, which is able to subsidize other activities.

> "The time for patent reform in Congress has passed."
> Bryan Lord
> AmberWave

So there is a concern that to stop this, we need to have better patents. But how do we get to that point. It's an important goal, because what we are seeing is that it can manifest itself in litigation and assertion activities.

Laurie: This is a classic comment because every time, no matter what the forum, the patent troll debate comes up, and sooner or later, it ends up being a discussion about patent quality. But what really upsets people is when bad patents are enforced.

Frank: But how do you define a bad patent? And how do you know how many bad patents are being issued?

Bergelt: Give me two weeks, I will show you bad patents.

Frank: But I don't think there is any evidence that patents have gotten worse. And, again, you get into the very difficult question of how you measure worse. There are more words in patent claims now than there were 10 years ago. And most patent lawyers think that the more words that are in a claim, the narrower the claim is going to be. Any kind of a mechanical analysis of patents to try to reach a quality metric is going

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to be somewhat rigid and somewhat imperfect.

I would have expected that if the patent office is being squeezed on the time side, you would see them let more go through because the incentive would be to just give up. At the same time, as a matter of practical experience, I don't see that and, statistically, you don't really see that either.

But what you do see is just so many more patents being issued. So even if the rate of bad patent issuance is held constant or is diminishing, the fact that you have so many more applications burdening the system means that you are going to have more bad patents coming out.

M&A: *Let me ask, just to shift the discussion back to M&A, how do you define good versus bad, and how much of a difference can it make in terms of price?*

Bergelt: Well, the first question you have to ask is whether it supports a fundamental technology. Does the market size or the market trajectory represent a significant opportunity? Is it valid? And is there prior art?

Hall: I think a "good idea" is anything that is worth a billion dollars, and you can just ask the inventor and that's exactly what he'll tell you.

Laurie: The old billion dollar market.

Cote: It is all contextual. How are you going to use your IP? Are you going to use it to start a company? Are you going to use it to go assert it against somebody? Are you going to use it to set up a joint venture and gain access to a marketplace? How do you intend to use it?

Hall: The value of IP is going to change. Ken, Keith and I can look at the same patent and come up with three dramatically different numbers because we are each looking at using it in a different way.

Lord: That's a good point. What patents have, among other uses, is that they can level the playing field between the incumbents and the new entrants in a given marketplace. Goliath probably had some choice words for David's slingshot, too. So there are natural reasons why the incumbents want to chastise new threats that come into the marketplace, and patents are a vehicle to help level that playing field.

If you go back to the patent reform debate, we have established companies that no longer have a substantial need for particular patents or a dramatically reduced need for patents in a particular stage of their life cycle. That's a good motivation to chastise the value of other patents in the marketplace.

On the flip side, when you have new entrants, such as universities, venture capitalists, startup companies and the like, a single patent can make the difference in terms of funding, commercializing, or realizing that billion dollar dream.

Hall: When you get down to it, really, a patent is essentially the legal right to exclude someone else from doing something. So, by that definition alone, every patent is essentially worthless. What makes it valuable is not the patent itself, but it's all the other stuff that we talked about earlier.

Frank: The fact that somebody wants to do something with it.

Bergelt: I have always thought of patents as a perception of rights until validated through litigation and/or licensing. What that really means is that it's hard to quantify because you can use it to support products, but it is all perception, until it's tested.

You may have been using it for years and people may say, "Oh, yeah, that's a great patent." And that may be the perception in the market that allows you to get licensing; allows you to sell products, but it may be a patent in which there is prior art.

Laurie: There is an interesting historical example of Bryan's comment about incumbents versus new entrants. In the mid 1990s there was a debate over software patents. The companies that were totally against it were the software-only companies that had been created and made a ton of money without ever having to worry about patents — Microsoft, Oracle, Adobe, Autodesk.

On the other hand, the patent incumbents, the AT&Ts, HPs, and IBM—which controlled a tremendous amount of important software developments — they didn't see a problem with software patents. To them it was just another design choice. Either do it in hardware or do it in software; who really cares? So in those days, the patent incumbents didn't have a problem.

The guys that had to deal with this new system and had to write checks for licenses, those were the ones who thought the sky was falling.

Frank: As somebody who has represented a lot of startups, I can echo that. In the mid 1990s, young software-oriented startups were very eager to get patents because they felt it was the only way that they could ensure that their product would not wind up in the next version of Windows. Otherwise, why would Microsoft go to the trouble of making a purchase when it could just duplicate the effort?

Bergelt: Now, you have attacks directed at earlier stage companies. It's not just incumbents, it's the new incumbents. Barracuda, for instance, is part of a lawsuit in which they have been attacked at a very early stage. They are not a gigantic company, by any stretch. But if you are trying to attack the business model, you attack the company, irrespective of the fact that it doesn't have deep pockets.

There is also a change in the landscape in that we're seeing the strategics coming in to attack these companies. It would be an irrational play for a "troll" because there is no significant recovery opportunity, but for strategics the ability to utilize patents to control the competitive landscape is another way we are starting to see patents used.

Laurie: This is one of the reasons that the VCs are more focused than ever on patents, because in the old days they didn't have to worry about attack, so they just ignored the patent defense. Now they do have to worry.

Lasinsky: Some of the non-practicing companies, or the companies that just own patents, will attack earlier stage businesses right before

their next round of funding. They know that if a company is looking for $10 million in its next round, immediately preceding that would be the perfect time to jump in with a lawsuit because they're not going to get funding against the backdrop of litigation.

Laurie: In the old days there was something called IPOs, you may remember those. The day the S1 was filed, the infringement notice letters started coming in, because the patent owners knew that that was when they were most vulnerable. The investment bankers would basically say, "Get rid of this," and it would be settled.

M&A: *We're talking a lot about risk, but generally speaking, would you say that corporations are beginning to view patents more as an opportunity as opposed to protection against the worst case scenario?*

Hall: Absolutely.

Cote: They are also using it as a ploy to get into an acquisition mode. They'll throw a suit on a target, which will soften them up to the point that a sale starts to look more appealing.

Hall: The more sophisticated companies, the larger entities, are starting to develop a number of different strategies around IP. You take a Fortune 50 company that maybe has a portfolio of 15,000 to 20,000 patents, and not all of those patents are going to be core to the businesses that they are in. Yet, they spend a fair amount of money, typically, to develop those patents that they most likely won't have any use for. So they start looking for other uses for them.

Some of those companies have gotten smarter about it; they've seen the wisdom of the auction and have taken that path. Other companies will cleave off particular patents and hope that someone, like an Altitude or another PE firm, will invest in the spinout. Other companies have simply negotiated an arrangement with a patent buyer around their non-core portfolios, because that buyer can find another use for those patents. But, absolutely, the big companies are looking at this very carefully.

Bergelt: It's a return on the R&D dollars spent. You can't leave these things just sitting there. You have got to look for value and try to completely squeeze out the sponge.

Hall: You can talk about R&D investment, but there are two components to that, the "R" and the "D." The bigger public companies are shifting to a model in which they are much more comfortable using the R&D budget to further develop existing products.

But when it comes to doing the basic research — positioning the company for something that is going to be 10 years out — that's very difficult to do. You are spending current dollars on an expense basis for a return that, if it even happens, won't occur until three chairmen later. So they are now looking to move some of the basic "R" off of their balance sheets, leaving it to the private equity firms or other shops that can afford to put money and time into it.

Lasinsky: It's interesting because the biotech and the pharmaceutical side figured this out 30 years ago. And they are the ones that are fighting for the strong patent system. They need it to be strong because they need the biotechs to develop strong, global patents so that they can pursue an exclusive deal or buy the company outright. And I think we are seeing the high tech space trying to figure that out.

Frank: The one thing that the biotech companies have done, for a very long time, is that they really mastered the art of licensing in the sense of understanding the relationship between risk and rate. And they have almost tiered the risk in terms of milestones that everybody understands: if you reach this milestone in clinical trials, then this is the kind of valuation we can give you. And if you are at this point, we have a different valuation. It is commonly understood and people have a framework to comprehend what the value is. It's more a matter of measuring the market as opposed to measuring the risk.

Other industries have had a lot more trouble doing that, because it's not really clear how you quantify the risk beyond the size of the market and your ability to produce a product. I was meeting with a startup earlier this week, and we had the exact same conversation. They weren't sure if they see themselves as a licensing company or as a product company. They don't know what they are going to evolve into. The only thing they know at this point is that they have to file a lot of patents in relatively short order because they have a lot of innovation that will eventually serve as the foundation for something.

But even as they don't know how they'll evolve, they are still thinking of themselves as an acquisition target. One thing that they didn't really think about was that the closer they get to developing a marketable product, the more risk that has been rung out of the intellectual property, which translates into more value for the IP.

M&A: *We've talked about how valuations depend on the context. Considering we have some interesting groups represented, I'd be curious to hear about the different business models and strategies.*

Cho: At Altitude, I don't think there is any preset business model. We are a private equity fund, with a fairly unique marriage of capital, IP expertise, and assets management capabilities. There isn't necessarily any single type of investment scheme.

We are interested in investing in IP-centric opportunities. That could be the outright purchase of a portfolio or an operating company. It could be the infusion of capital into an existing company that may be trying to monetize its IP assets and they are running low on cash. So it runs the gamut. The one thing that interests us the most is a company with strong, complex IP, because we have the ability to take a deep dive and evaluate the associated risks.

M&A: *John, can you describe Intellectual Ventures? It sounds similar, but from what I can tell, you are more interested in buying raw IP?*

Hall: I think our model, for the moment, is a bit unique. We have had a fair amount of success raising capital, very long-dated capital, and we are investing in a stage prior to the stage that Altitude would be investing. We are investing either through inventing it ourselves or by partnering with someone else or buying it from someone. We are investing in the raw invention itself, the patent.

To use Keith's term from earlier, we are an aggregator. Our view, right or wrong, is that the way you create a value proposition for someone, a big company, for example, is not necessarily with one patent or two patents, but with a large number of patents. And when

you aggregate a sufficient number of patents in a fairly concentrated space, it becomes relatively easy to then go out and license that portfolio of patents because you have done a service for the folks that are taking the license.

You can define the service in a number of different ways. Let's say you aggregated 5,000 different patents in a given space. You can then go knock on someone's door, and at a minimum, say that you have just eliminated 5,000 potential lawsuits. It can change the tone of the conversation.

Also, when you have a portfolio of that size, you are going to have a lot of inventions that a particular company isn't using, and perhaps should be. So now you are talking about an enabling strategy, in which you can go in and say, "Hey, these patents can make your product better, faster, smarter, prettier, whatever." We think it presents a compelling value proposition, and our experience to date leads us to believe that we are probably right.

M&A: *For the advisers in the room, when you are selling IP do you find that there is a typical audience of buyers? Or is it more of a mish mash of strategics, specialized investors, aggregators, et cetera?*

Lasinsky: From our standpoint at Ocean Tomo, everybody is on the list. The dynamics have really changed over the last three years. At our very first auction, a number of the lots sold for $10,000. Now, it's rare if something sells for less than a hundred thousand dollars. So you don't get there without having access to everyone. And everyone knows that they need to be in this game.

Laurie: In our brokerage business we distinguish, on the sale side, between the strategic buyers and the defensive buyers. The strategic buyers, as I said before, are the ones that are seeking to gain leverage against one or more specific rivals. To us, that usually represents the highest value you are going to get for a patent.

The defensive buyers are the ones that are just trying to minimize their risk, primarily their risk from a non-practicing entity.

The risk to any operating company is their exposure under a particular patent. The gain to the asserter is aggregated across all of the companies that might be infringing on that patent. So an operator, in a competitive auction, can't compete on price with an assertion aggregator. That's why you're seeing operators put together a consortium to pool their money and level the playing field.

Bergelt: To that point, you are going to start to see treaties between defensive patent pools. It will allow companies to further leverage the amount of money that goes into it, creating a cross-fertilization in which people gain access to each other's patent.

M&A: *We've discussed how the traditional investment banks tend to avoid the IP discussion. But we're starting to see IP play a bigger role in the distress market. For instance, in a lot of these consumer-oriented bankruptcies, the IP is the only thing that survives. Sharper Image comes to mind. Will this translate into more attention on the asset class from the traditional banks down the line?*

Cote: IP is often the last asset to be liquidated. But, just to expand the point a little bit, some ventures that never got started because of the bubble bursting in 2000 and 2001, the only assets they hold is the intellectual property. And they are finding people approaching them saying, "We would like to acquire that IP, because now it's got some age on it, others are using it without the benefit of a license." That gives the assets some true value.

One of the things that you have been dancing around is how do you value an entity that is only IP? Most often we are talking about ventures or small companies. I've worked at R&D centers, whose sole job is to create IP. Generally, it is going to the parent of the R&D center, but how do you evaluate an R&D center's IP if it hasn't been used by the parent company?

The investment bankers have no clue as to how to put a value that. So there is a sophistication now taking place in which people are becoming more comfortable with it, although they haven't gotten there yet.

Bergelt: We are not going back either, because the asset mix of companies is not changing and reverting back to hard assets. That's what's helping to keep this trend moving forward.

M&A: *I've also heard that fair value accounting will only add more thrust to the trend.*

Lasinsky: It already is. If you license a piece of intellectual property and you pay for it in a lump sum or you do some sort of a strategic cross-license, fair value accounting is requiring that you put that asset on the books. And maybe you received what you paid for that piece of intellectual property, or maybe it's less valuable or more valuable. The accounting firms are forcing companies to figure out the value of the IP.

Bergelt: We mark to market. It's usually a conservative valuation, but we do recognize some appreciation in assets. As you add more assets, you buy a portfolio that may have 12 applications and a portion of the patents granted, then you'll recognize an appreciation. In other cases, if there is some aging, you might recognize a diminution.

Laurie: Again, when you move to M&A, things change a little bit. In a hundred million dollar deal, the investment banks may turn to the accountants and ask, "How much of this purchase price should be allocated to IP?" But it has little, if anything, to do with reality.

The way you approach valuation depends on why you are doing it. If you are doing it for financial reporting, you approach it one way. If you are doing it for a deal negotiation, you approach it another way. Most of the guys who are really good in the valuation area say I can't give you a valuation until you tell me who the buyer is, because there may be a ten-fold difference between Buyer A and Buyer B.

Hall: It is interesting, because as the accountants become more involved in putting values on intellectual property, it becomes yet another challenge for those of us who play in this space.

I joked earlier about how every inventor thinks his idea is worth $1 billion, but now you go and talk to a corporate owner of IP, and they'll say that they want to sell it for "X." So you naturally ask, "Why 'X?'" Their answer is because that is what their cost basis is. But what does their cost basis have to do with anyone else's interpretation of value? Absolutely nothing.

So it now becomes a constraint. We have to figure out what to

do with this cost basis that was perhaps artificially derived.

Laurie: The most powerful method of valuation, at least in my opinion, is to find comparables. Even though patents are unique and the idea of a comparable is not the same as it is in real estate, you can still get close. And I think that there are a number of initiatives going on to try and build a database of comparables. Of course, the only publicly available comparison data, other than SEC filings for material deals, is the Ocean Tomo auctions. Gathering 2.0 has an initiative to create a database; PatentFreedom is creating a database, of sorts. So, to the extent we can introduce more comps to the marketplace, the valuation metrics will become better. At the same time, it will never be an exact science.

Trademarks are a lot easier because there is a lot more data out there. They probably will always be easier because they are much more fungible. It's very clear that it is not about the engine you put behind something; it's about the brand. The trademarks will actually sell.

I don't know if you are familiar with Le Tigre, but the brand was dormant for about 12 years. Somebody bought it for about $1.5 million, and three and a half years later, sold it for $35 million. At its peak, the company's revenue reached about $400 million in the late 1980s. But it just demonstrates that there can be residual value in brands that are completely dormant. You can go down a whole list of brands that have similar stories.

Lasinsky: As the price discovery gets faster, it is just going to drive prices up dramatically. We talked earlier about how the traditional investment banks aren't necessarily pricing IP into a deal, but that is shifting. I know in some of the stuff that we are working on, they are looking at how much of the free-cash flow is coming in from the licensing income. And then they are doing really significant due diligence on that, trying to understand how the free cash flow will change as the intellectual property portfolio changes.

They may not be thinking about dormant IP, but as soon as they can put a number on that free cash flow and assess the risk to that, they'll realize how important it is.

Cote: They can monetize that because they can track it. The revenue is coming from a certain number of projects that have been around for quite a bit of time, so there is a track record and a revenue stream, but there is also an end point because those patents are going to expire and the markets are changing.

But how do you evaluate those new technologies that just had their first patents awarded? And the ones that are in application? Or the new applications that can be applied to existing patents. They don't know how to deal with that.

M&A: *Given all of this, where will the IP market be in five or even 10 years?*

Laurie: I think the IP marketplace and specifically the patent marketplace, will continue to expand, and valuations will continue to rise, especially for the larger portfolios. There will be an emphasis on quality. A lot of this is going to be driven by an increasing number of institutional investment firms discovering IP as a viable alternative asset class. The real winners will be the ones who hit the right sweet spot in terms of balancing quality and quantity in a portfolio.

Frank: The combination of an increasingly liquid and accepted market for trading IP rights and globalization is going to lead to more deals and less litigation. You are going to see companies come to terms with the idea that their IP is really not a lock on the door; it is more of an opportunity. And they are going to be forced into relationships with other companies out of necessity and that's going to increasingly be leveraged on intellectual property.

Lasinsky: There will to be a lot more institutional knowledge around intellectual property. And that, importantly, is going to result in better due diligence and better tools to analyze it, probably like we have never seen before, as these guys put more and more capital toward these assets. M&A