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monetizing intellectual property to improve financial performance

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AUTHOR

Michael A. Gollin
Partner
Patent Prosecution
Chair, Life Sciences
magollin@venable.com
202.344.4072
Bio:
www.venable.com/michael-a-gollin

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EXECUTIVE SUMMARY

Companies can improve their financial performance by monetizing patents and other intellectual property (IP). The goal is to increase the assets and revenues that derive from technology and innovation, while decreasing liabilities and expenses. A good beginning is to prepare an IP financial report, adapted from conventional financial statements. Such a report includes:

(a) an IP balance sheet listing IP assets such as patents and trademarks, and liabilities such as infringement liability, and

(b) an IP income statement quantifying the amount of income from IP, and its cost.

Managers can use an IP financial report to track return on IP investments and to improve performance over time. They can find practical strategies for increasing assets and income and reducing liability and costs by placing a value on each asset. For operational purposes, IP assets should be valued along two axes:

(1) internal value, i.e. relevance to the company's core mission and

(2) market value.

Core assets with high market value merit the most intense level of IP protection, through acquisition and in-licensing. Core assets with low market value should be maintained at moderate cost. Non-core assets with high market value should be sold or licensed out, and non-core assets with low market value should be abandoned to reduce costs. Managers who know the value of their assets can do a better job. Dealmakers can negotiate harder for core assets, and be more flexible with non-core assets. It may be worth fighting over core assets, while quitting or settling may be the best approach for non-core assets. These general guidelines hold true in most situations, but will lead to very different results depending on the business goals of a company and the value of its various assets.

Monetizing IP requires skillful management, bringing together business leadership with the legal and creative teams. Companies who follow this approach can achieve improved performance.

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In the decade and a half since David Bowie bundled up his future music earnings into copyright-backed bonds to pay his taxes, RoyaltyPharma has securitized billions of dollars of drug patent royalty streams, countless "trolls" have bought and enforced patents for cash settlements, and Ocean Tomo's patent auctions have become routine. Disney bought Marvel Comics for $4 billion based mostly on its copyright-protected comics and movies, and trademarked cast of characters. An alliance of technology giants bought Nortel's patents for $4.5 billion, and Google bought Motorola's patents for $12.5 billion. By now, all companies should be considering how they, too, can increase the assets and revenues that derive from their IP, while decreasing the associated liabilities and expenses.

According to many estimates, 50-80% of corporate value is reflected in intangible assets as opposed to cash, stocks, physical assets or real estate. Intangible assets include the basic IP rights that are legally recognized as property: patents on inventions, trademarks for brands, names and logos; copyrights in media and software; and trade secrets in technical and business information. Intangible assets also include loosely defined but extremely valuable internal attributes like human capital, know-how and operating systems, as well as reputation and external relationships, and the resulting expectation of growth known as goodwill. These assets are not usually listed on conventional balance sheets, because the accounting standards and practices for intangible assets are erratic, uneven and not much help in managing IP. Therefore, intangible assets may seem disembodied and disconnected from money, existing in some kind of shadow economy. As an IP attorney, working in tough economic times, I have become convinced that management decisions relating to IP and other intangible assets can be improved substantially by tying them more closely to money, and by considering basic accounting principles.

Most companies can monetize their IP, and the triggers for doing so are many. These include buying, selling or starting up a business or product line; forming a new strategic partnership; or making strategic investment decisions. Technology companies can monetize their patents and trade secrets in new drugs, consumer products or e-commerce services. Media companies can monetize copyright in their holdings. And any company with strong brands and a presence on the Internet should be looking at monetization via trademark protection and licensing. Even nonprofits can monetize their IP to help meet their charitable goals, through brand recognition, new revenue sources and creating bargaining chips for partnerships. Whenever these companies make budget decisions about investing in their own innovations, or acquiring assets from others, they should try to monetize their IP.

How can corporate leaders accomplish these goals? The answer will be different in each industry and for each company. Companies may protect their own IP assets or acquire them; they can out-license to others, litigate or avoid litigation. A good way to find the best path for each company is to consider what we may refer to as the basic arithmetic and geometry of IP monetization.

IP financial reporting arithmetic

Simply put, a successful business is one that has a strong financial position. It has more assets than liabilities, and more income than expenses. Generally speaking, these corporate characteristics are captured in a financial statement or financial report, including:

> (1) a balance sheet listing assets and liabilities, with assets minus liabilities giving the resultant shareholder equity, and
>
> (2) an income statement showing income, expenses and income minus expenses giving the resulting profit or loss.

Thus, there are four basic categories of data in a financial report – assets, liabilities, income and expenses – with two ultimate sums – equity and profit. The higher the equity and profit, the stronger the company. The lower they are, the weaker the company. In this light, managers should pursue IP monetization strategies if they can help demonstrate higher corporate equity and profits.

The liabilities that relate to intellectual property are even more unevenly reported. IP-related risk and liability can include legal exposure for infringement damages or the cost of injunction in litigation, out-licenses to other parties, government march-in rights due to federal funding, liens and other IP security interests. There are only a few ways to manage such risks – buy insurance (if available), contract away the risk to someone else, or manage and bear the risk internally.

Finally, although expenses for obtaining IP rights and income from licensing are sometimes accounted for as separate items in an income statement, this is rarely done in a systematic or consistent way that helps manage the assets to best effect. For example, when patents are acquired from others, they can be counted as capital assets, but the same patents developed through internal research are not.[1]

Neither GAAP, FASB, IASB, nor income tax reporting provide much help for IP managers. Accountants toil away with archaic rules about intangible assets that bear little relation to the innovation strategy and efforts of R&D, manufacturing, business development, marketing and sales teams. One good reason for

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[1] See Deloitte, "Summary of IAS 38 Intangible Assets," IAS Plus, available at . http://www.iasplus.com/standard/ias38.htm (November 1, 2011)), and A. Damodaran, "A Primer on Financial Statements," available at http://people.stern.nyu.edu/adamodar/New_Home_Page/AccPrimer/accstate.htm (November 1, 2011.

finding a workable system for accounting for IP assets is that "what gets measured, gets done." Thus, measuring IP assets can bring its own rewards.

The approach to IP financial reporting set forth borrows from the basic principles of accounting, but takes liberties where necessary for IP management. This approach may lack the rigor of accepted standards, but also avoids fallacies as noted above. Ultimately, along with organizations such as the Intangible Asset Finance Society, I hope that IP managers can take the lead in developing new accounting standards, and that accountants will then improve and apply them in the future.

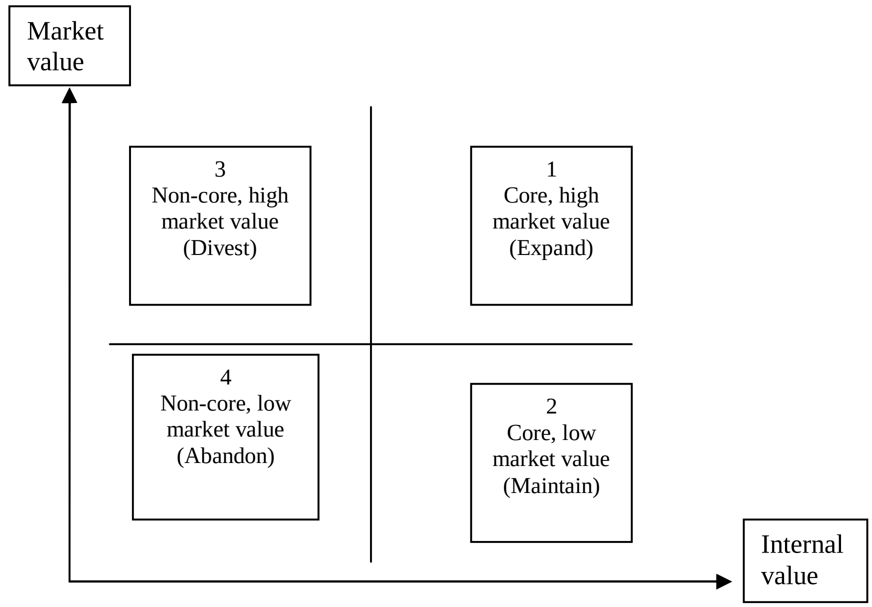
Setting up an IP-oriented financial statement can free up management to evaluate and use IP more directly for corporate benefit. A simple IP financial statement includes an IP balance sheet and an IP income statement. The IP balance sheet can be based on a typical IP portfolio spreadsheet – an inventory of patents, trademarks, copyrights and trade secrets, along with other intangible assets if desired, in suitable categories – with at least a rough valuation of each asset. (Valuation is a separate topic touched on briefly below.) The IP balance sheet also shows IP liabilities – payments due for acquiring rights, the risk of infringement of IP rights of others, risk of being blocked from a lucrative market, etc., with a rough monetary valuation of a reserve for each. Assets minus liabilities gives a rough valuation of the IP equity of the company.

An IP income statement includes first, all income derived from the company's IP assets, including licensing revenue, proceeds from assignment of IP rights, litigation recoveries and a portion of sales attributable to IP-based exclusivity (such as a percentage of product sales for a patented and trademarked product). The expense side includes all procurement costs for patent prosecution, trademark prosecution, in-house IP staff, outside counsel, litigation expenses, and royalties and payments attributable to avoiding the IP rights of others. The maturity of the product and the pipeline for improvements can be factored into projections. For example, costs of obtaining IP assets often precede revenues, and revenues that derive from selling products or services may be hard to attribute to specific IP assets. But on the whole, the sum of income and expenses can show roughly whether IP is a net gain or loss for the company.

This IP management arithmetic allows a company to determine its performance in terms of whether it has more IP assets than IP liabilities, and whether it has more IP income than IP expenses. Performance can be compared year over year, and compared to competitors, and adjustments can be made in IP management to improve performance. As explained in the next section, IP management approaches can be explained by a sort of geometry.

IP monetization geometry

The central point in strategic management of IP is to categorize each item or asset according to two types of value – internal and external. First, how important is the relevant technology or asset to the company's own operations? Second, how valuable is the technology or asset in the marketplace? With the answers to these two questions, we can place each IP right or intangible asset in one of four quadrants, and manage them accordingly.



The first quadrant, in the upper right, includes core assets of high importance to the company, with high market value. For a pharmaceutical company, this would include the chemical structure of a drug. A razor blade design would be a core high-value asset for a consumer product company. For an e-commerce company, this quadrant would include a software application for managing internal and external communications. Such assets merit the highest level of protection, to maintain the company's competitive advantage, and also to license or otherwise generate revenues from the asset. Companies should aim to acquire and protect assets in this category, to build their IP portfolio.

The second quadrant, in the lower right, contains assets that are valuable within the company, but have lower value in the marketplace. The pharmaceutical company would place most methods for manufacturing its drugs here; the consumer products company might include the network of suppliers and specifications for its razor parts; and the e-commerce company might view personnel performance evaluation software in this category. These assets should be protected from loss or erosion, but at a lower level than core assets in the first quadrant. Trade secret protection is appropriate, some patenting is possible, and there are other lower cost approaches.

The third quadrant, in the upper left, offers the greatest opportunity for generating income from IP assets that have no intrinsic value to a company. For example, these assets may relate to an older technology that has been transcended by recent developments. But they still have high value to others, and are prime candidates for spinning out via licensing or assignment. For example, in 2004, Toyota licensed hybrid technology to Ford, amid reports Toyota was moving on to a new generation of hybrid technology. (Ford and Toyota just announced a broader alliance to apply hybrid technology to pickup trucks.) In 2011, Kodak announced plans to sell its digital imaging patent portfolio for over $1 billion. (But the project faces challenges because many of the patents have already been licensed for certain uses.) Astellas received over $600 million in exchange for its patent royalty rights in diabetes drugs, and will use the cash from that non-core project to invest in its core disease research. Revenue-generating methods for this quadrant include IP securitization[2] and many other approaches,[3] some of which have already been patented.[4]

The fourth quadrant, in the lower left, includes "lost" assets which no longer have value within the company or in the market. Whatever the sunk cost in these assets, even if hundreds of thousands or millions of dollars have already been spent to acquire them, if there is no buyer for them, and no relevance to the company's operations, they should be abandoned, pruned and killed off to conserve resources to build assets in the first three quadrants. Such lost assets may also be donated to charity for a tax deduction, although the valuation rules are quite strict and the valuation may be minimal. Psychologically, it is very difficult for companies to kill off IP assets, but using the geometric quadrant approach described here, the case for abandoning those obsolete assets becomes quite compelling, as does the need to invest resources in the more valuable assets.

Several general lessons can be drawn from this four-way categorization. Companies should aim for having many assets in the first category (high internal and market value), with some assets in the second category (high internal and low market value). As internal strategies change, assets that were in these core value quadrants may shift over to the low internal value quadrants – the third (with high market value) and fourth (with low market value). If so, the management approach should change toward divesting or abandoning these assets. Also, as market forces change, assets that were once in the first and third category (with high market value) may drop down into the second and fourth quadrants (with low market value), reducing the recommended intensity of protection.

Assume assets can be monetized. Larger companies face challenges in deciding which assets are core and which are non-core, but at least that decision is an internal one. It is harder to determine whether a technology or asset has high or low market value. Trial and error may be required to obtain enough evidence for a reasoned decision about market value. A proactive approach to monetizing IP assets can begin with the hypothesis that an asset has high market value. Try to license it (if it is a core asset) or sell (if it is a non-core asset). If diligent efforts to sell the asset fail, then this supports re-categorizing the asset as one having low market value. (That is, assets in the first and third

[2] *See, e.g.,*. Michael Gollin, *Driving Innovation: Intellectual Property Strategies for a Dynamic World* (Cambridge 2008), pp. 322-325.
[3] *See, e.g.,* Ian Ellis, Maximizing Intellectual Property and Intangible Assets: Case Studies in Intangible Asset Finance, Working Paper #07, Athena Alliance, http://www.athenaalliance.org/apapers/MaximizingIntellectualPropertyandIntangibleAssets.htm (accessed November 1, 2011).
[4] Block et al, U.S. Patent 7,716,076, "System and method for financing an insurance transaction."

quadrants would fall to the second and fourth quadrants.) In short, to maximize financial returns, assume high market value, test that assumption and reject it if no market can be found.

Litigation defense. The same system of mapping the value of internal corporate activities into quadrants can help decide how to respond to the threat of enforcement of IP rights belonging to others. For core activities in the upper and lower right hand quadrants (the first and second), quitting is not an option, and the company must decide whether to acquire the right to practice the technology, design around to avoid the IP right or litigate to win. If the market value of the asset is high, as in the first quadrant, expect a tougher battle and more expensive resolution than if the market value is low, as in the second quadrant.

Non-core corporate activities, on the low internal value quadrants, present a simpler situation. Here, the best option may be simply to quit that activity. For activities in the third quadrant (low internal, high market value), although the activity is no longer central to the company, there may be some residual infringing activity, and if so, it may be necessary to settle past damages. For fourth quadrant activities, where the activity has low market value (and hence low value to the IP owner), quitting might be free of liability, but costs should be minimized.

Valuation

Each of the steps laid out here, whether the arithmetic of financial reporting or the geometry of categorizing assets, requires some kind of valuation for each asset. Unfortunately, valuation of IP is complex and results are unclear. Nonetheless, reasonable approximations can readily be made, and these are better than nothing, and generally good enough to improve financial performance.

There are four basic approaches, each with strengths and weaknesses in any given situation.[5] First, the cost approach (sunk cost or replacement cost) is perhaps the simplest – how much money did the asset cost to produce, or how much would it cost to replace it? This includes acquisition of IP rights, and might include costs for research and development (if they are not treated as a separate expense). However, cost has little relevance in setting a market value. Second, the income approach focuses on net present value or discounted cash value. This is a sound financial model, but applies only to assets with actual or predictable revenue streams, such as a running royalty. In some cases, it may be possible to estimate income value by looking at IP monetization as if it were a standalone business. Third, fair market value is determined by reference to comparable assets, but many IP assets are unique, and few are traded in markets, so there are rarely any true comparables. Finally, there are hybrid methods, such as rules of thumb for royalty percentages, and approaches for special valuation situations such as converting IP assets into securities.

[5] *See Driving Innovation*, pp. 207-225.

Typically, an IP valuation project involves running each of these four models, finding a range of values, and selecting a reasonable figure from that range. The absolute number is not as important as the relative figures. It is a good sign if value increases over time, and responds to investment. It is a warning sign to see that value is not increasing, or is less than the sunk investment costs. As long as the valuation approaches are used consistently, the IP financial statements and core/non-core analysis can become vital tools for strategic management of IP.

Improving IP management

Having briefly described the what, when, why and how of IP monetization, we should touch on the question of who should be involved? Because the decisions to be made may impact fundamental business strategies, IP monetization is best conducted with the leadership of the CEO with support from the board of directors. The key participants include the chiefs of research, marketing and finance, as well as IP counsel, both in-house and outside. Some projects may require specialized expertise from consultants in business development, valuation and other aspects of accounting.

Most important is to assemble a team that is competent in business, technology and law, one that knows the business strategy of the company, its market, its technology and operations, and the legal constraints and possibilities for building IP assets and avoiding liabilities. Several examples show the range of approaches that the IP management team might pursue.

For smaller companies, such as a research-based start-up with university-derived technology and angel funding, the emphasis may be on building up core assets, controlling the costs of acquiring IP rights, and avoiding infringement liability. As funding and IP assets increase, the next stage is to focus on generating revenue from IP, and supporting strategic collaborations.

For a well-funded private company contemplating an IPO or sale, a more sophisticated IP strategy will focus on IP monetization as an organizing principle. And the leaders in IP monetization – the biggest multinational technology companies, and those involved with securitization, purchasing patent rights for enforcement, auctions and so on – use their leverage to change the entire IP landscape in their favor, through statutory and regulatory changes and new business practices.

Conclusion

Using the tools described here, every company can open up immediate opportunities to increase revenues and assets, and to reduce expenses and liabilities. The result will be an improved financial performance, with higher profits and equity. Strong financial statements bring many benefits in terms of access to capital, opportunities for collaboration and corporate growth. If we put intellectual property to work to help achieve these goals, then it is doing its job, and so are we.

Venable office locations

BALTIMORE, MD
750 E. PRATT STREET
SUITE 900
BALTIMORE, MD 21201
t 410.244.7400
f 410.244.7742

LOS ANGELES, CA
2049 CENTURY PARK EAST
SUITE 2100
LOS ANGELES, CA 90067
t 310.229.9900
f 310.229.9901

NEW YORK, NY
ROCKEFELLER CENTER
1270 AVENUE OF THE
AMERICAS
25TH FLOOR
NEW YORK, NY 10020
t 212.307.5500
f 212.307.5598

ROCKVILLE, MD
ONE CHURCH STREET
FIFTH FLOOR
ROCKVILLE, MD 20850
t 301.217.5600
f 301.217.5617

TOWSON, MD
210 W. PENNSYLVANIA AVE.
SUITE 500
TOWSON, MD 21204
t 410.494.6200
f 410.821.0147

TYSONS CORNER, VA
8010 TOWERS CRESCENT DRIVE
SUITE 300
VIENNA, VA 22182
t 703.760.1600
f 703.821.8949

WASHINGTON, DC
575 7TH STREET NW
WASHINGTON, DC 20004
t 202.344.4000
f 202.344.8300