

Clearing the underbrush

Recent regulatory, legal and legislative developments in the US will lead to the maturation of the IP asset management market. This is very good news for rights owners, investors and lenders

By **Cameron Gray**

A complex body of law regulates intangible asset management in the US and the environment is volatile. The Supreme Court has recently decided five intellectual property cases, with potentially far-reaching implications for corporate intellectual property (IP) asset management. On 18th April 2007, bipartisan legislators in both the Senate and House of Representatives introduced patent reform legislation termed the Patent Reform Act of 2007. Corporations, IP buyers and sellers, IP investors and lenders are on notice that the strategy underlying patent prosecution and litigation is likely to shift markedly.

Antitrust law, as it relates to intellectual property, and accounting standards provide additional regulation of intangible asset management. In April 2007 the US Department of Justice (DOJ) and the Federal Trade Commission (FTC) jointly issued their report *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition*. The press release described the Report's focus as: "Refusals to license patents, collaborative standard setting, patent pooling, intellectual property licensing, the tying and bundling of intellectual property rights, and methods of extending market power conferred by a patent beyond the patent's expiration." Recent developments in accounting bear noting, especially Financial Accounting Standard No 157, Fair Value Measurements (SFAS 157), draft standards introduced by the American Society of Appraisers (ASA) and FASB Statements 141/142.

The complex and changing regulation of intangible asset management carries

tremendous implications for corporate IP management, IP-based investment and IP-based financing. A number of private sector services and financial products have emerged in recent years, fundamentally changing the prospects for IP asset monetisation and commercialisation. A period in the IP marketplace may shortly develop where the dense thicket of poor-quality underbrush will be substantially cleared and the distribution of IP assets will become less skewed. Market participants stand to benefit by harnessing the power of new marketplace mechanisms to improve corporate governance, IP management and IP investment programmes.

Supreme Court decisions

The Supreme Court has decided five intellectual property cases since March 2006.

Set against the sweeping changes of the Patent Reform Act of 2007 (see below), the Court's decisions focus on the relative contribution of damages and injunctions to patent value and litigation strategy, and display concern with escalating jury-awarded damages in patent infringement litigation and a perceived deterioration in patent quality. The Court's focus is market-friendly.

In modelling expectations of litigation exposure, sources of volatility can be found in the dispersion of plaintiff win rates across venues, the relative contributions made to damage awards by lost profits versus reasonable royalties and levels of volatility associated with the increasing use of jury trials over bench trials. Anecdotally, wide variation persists between jurisdictions, creating a valuable free option for plaintiffs alleging national sales of accused products. Plaintiffs' returns on investing in

enforcement can be compelling where a favourable venue is assured and the litigation strategy succeeds in claiming an overly broad royalty base and therefore commanding negotiating leverage through escalating litigation exposures.

The *eBay v MercExchange* decision, handed down in 2006, counteracts these developments by reducing the viability of threats of injunctions in dictating negotiating leverage for plaintiffs. The market effects of the Court's decisions will be felt most acutely in their effects on pre-trial settlements and litigation-related settlements. The January 2007 *MedImmune v Genentech* judgment may influence the dynamics of licensing as it sanctions licensee actions for invalidity without the prior requirement for breach or termination of the licence agreement, but licensing practice can continue unaffected. *eBay* may materially change the calculation of patent litigation exposure and the April 2007 *KSR v Teleflex* decision reflects heightened sensitivity to patent quality. Together, these decisions may influence valuations driving due diligence on IP-based investment deals. If *KSR* is the beginning of a trend to improve patent quality and *eBay* results in effectively reducing litigation exposure to damages when the patent holder cannot be reasonably expected to compete horizontally, the market will have benefited.

As the post-*eBay* legal environment evolves, sufficient elements to support injunctive relief will be described, refining the market's modelling of litigation exposure.

The international context for patent enforcement stresses the use of private sector services and improved risk management products. A 2004 report of the UK Patent Enforcement Project Working Group (*Scoping Study: Report of the Patent Enforcement Project Working Group*, Michael Edwards & Associates, 16th June 2004) advocated more widespread use of ADR in IP disputes and the creation and administration of a mutual insurance association for patentees providing indemnity insurance cover for its members. Interestingly, the UK Intellectual Property Advisory Committee Report on the enforcement of patent rights urged an IPR audit as a part of any company's annual audit. The 2003 *CJA Report*, commissioned by the European Commission, recommended that the basic statistics needed for assessing risk by insurance underwriters be provided by governments. Recent developments in patent quality metrics offer potentially improved models of pricing risk by insurance underwriters with substantial IP expertise.

Patent Reform Act of 2007

After much anticipation, the 2007 incarnation of patent reform legislation was introduced in

Recent Supreme Court intellectual property decisions

Case	Decision	Market effect
<i>Illinois Tool Works v Independent Ink</i>	Unanimous	Muted; reconciles with DOJ/FTC standard for tying arrangements
<i>eBay Inc v MercExchange, LLC</i>	Unanimous	Reduces the probability a plaintiff not practicing the patent will be granted an injunction; decreased leverage for non-practising patent owners' enforcement
<i>MedImmune v Genentech</i>	8-1	Uncertain long-term effect on licensing strategy as licensees can opt to pay and sue so long as contractual terms don't enforceably exclude initiation of a declaratory judgment action
<i>Teleflex v KSR International</i>	Unanimous	Increased application of obviousness as a grounds for patent invalidity; long-term increase in patent quality
<i>Microsoft v AT&T</i>	7-1	Restricts extraterritorial application of patent law in damages calculation

both the House of Representatives and the Senate in April.

If enacted, the proposed legislation would have a dramatic impact on the patent system, including patent quality, damage awards and the growing mesh network problems (elsewhere called the royalty stacking problem) whereby the relationship of patents to subject products or processes is poorly defined and contributes to volatility and valuation uncertainty. The proposed changes to Section 284, whether further modified or left intact, will improve predictability and narrow the range of investment expectations of litigation exposure or prospective returns on enforcement, leading to more efficient markets for commercialisation and monetisation of IP assets, as well as improved use of patents as security for risk capital.

The mesh network problem suffers from two overlapping issues: the perception of deteriorating patent quality; and proliferating technologies where hundreds or even thousands of patents may reasonably be expected to cover one product or a product

family. Improvements in patent quality and a standardised, market-accepted relationship between a patent and its contribution to a covered product are two central issues to the vitality and long-term viability of the US patent system.

Corporate IP management should explicitly reconsider the balance between selling and licensing intellectual property implied by Section 284 changes to litigation exposures, as well as those implied by the Supreme Court decisions and the other elements of the Patent Reform Act of 2007 impinging on the risks and costs of maintaining ownership of IP when expected value is uncertain or low. Recently introduced marketplace mechanisms by which IP can be bought or sold at auction and IP asset sale services that permit IP managers to use more precise market data to model expected sales proceeds from available monetisation schemes are important inputs to corporate models of sale versus licence. Effective use of the secondary market for patents and close monitoring of legislative changes and IP case

Key features of the Patent Reform Act of 2007

Statutory provision	Effective change	Addressed to:
§ 102	Transition to first to file	Int'l patent law harmonisation
§ 135	Elimination of interference proceedings, institution of derivation proceedings	Int'l patent law harmonisation
§ 115	Permits substitute statement in lieu of executing inventor's oath or declaration	Ease of filing without inventor's cooperation
§ 118	Permits assignees to file applications in their own name	Ease of filing without inventor's cooperation
§ 284	Reasonable royalty applies only to economic value properly attributable to specific improvement over prior art	Restricting damage award calculation method
§ 284	Limiting application of entire market value theory in damages	Restricting damage award calculation method
§ 284	Limiting grounds for wilful infringement	Restricting damage award calculation method
§ 273	Establishing prior user rights and defences	Patent validity
§ 321 et al	Providing post-grant review procedures	Patent validity/reduction in litigation estoppel effect
35 USC § 6	Replacing Board of Patent Appeals and Interferences with the Patent Trial and Appeal Board and altering duties of Board members	Institutional roles
28 USC § 1400; 28 USC § 1291	Altering venue requirements and providing for interlocutory appeals after a claim construction decision	Plaintiff venue options and procedural change

Adapted from http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4150

law will enable US businesses to extract maximum value from their IP portfolios while effectively managing risk.

Antitrust law

Antitrust limitations on intellectual property constitute an additional source of regulation of the IP marketplace. The Department of Justice's 1995 *Antitrust-IP Guidelines* dictated the acceptable forms patent pools could take, and the subsequent pools that have passed muster under the guidelines have created a *de facto* market standard for patent pools covering consumer electronics and related products. Less clear is what will lower the barrier for migration of patent pools into other industries and product groups where the value proposition remains. Underlying the theoretical issue is the mesh network that characterises the relationship between patent and covered product, ie, allocating a weighting to each patent in the relevant group. The theoretical difficulty is that patents do not automatically identify product markets conventionally considered in antitrust review, while products embodying a portfolio of patents may not have viable market substitutes.

Considering the issue of what antitrust authorities should do with intellectual property licences where the validity and the scope of a patent is uncertain, commentator Willard Tom noted in 2003 that: "Eight years after the [1995 Antitrust-IP] Guidelines, there still is no settled approach to antitrust enforcement in these cases." Indeed, one approach is to inquire factually whether the patents owned by one or both parties would have blocked the other from competing (applied by the FTC in the proposed Summit-VISX patent pool for laser eye surgery). However, this inquiry is tremendously resource-intensive and trying the issue eliminates the value of efficient settlements. The MPEG-2 and DVD6 pools outsourced this responsibility to an independent expert, with necessity measured relative to a market-accepted standard.

Antitrust law balances rewarding innovation and preventing anti-competitive conduct. Modes of addressing patent uncertainty should be evaluated according to the cost of implementation, likely efficacy as a behavioural deterrent, perceived reasonable certainty and potential remedies. The antitrust decisional rules influence marketplace participants' competitive conduct, but they do so through the predictability of participants' expectations. While the flexibility of the antitrust analysis

creates value, the codification of some rules can stimulate private sector development of efficient risk transfer mechanisms as well as catalysing the efficient extension of risk capital to IP owners.

Three flavours of antitrust merger interest in IP issues are: the combination of patents together may suffice to block or delay future entry by others; one of the parties' competitors might have threatened and/or initiated patent litigation which, if successful, could materially change the competitive landscape; and the merger is a global settlement of threatened or ongoing patent litigation which, if successful, would eliminate a large competitor from the market (eg, Boston Scientific's 1995 acquisition of Cardiovascular Imaging Systems Inc and SCIMED Life Systems).

ASA IP statement

Legal intangible	Factors to be considered
Patents	1) Jurisdictional coverage 2) Status of registrations 3) Breadth of patent claims 4) Alternatives to the patented invention 5) Risks of infringement and invalidity 6) Possibility of blocking patents
Trade secrets	1) Efficacy of measures undertaken to protect secrecy 2) Likelihood of a competitor legitimately discovering the secret 3) If potentially patentable, benefits, costs and risk of patenting v protecting as a trade secret
Copyrights	1) Whether the copyright is for the original work or for a derivative
Trademarks	1) Ability to be extended to related products or services without infringing on the trademarks of others 2) Nature and status of registrations 3) Likelihood of abandonment being found on the basis of non-use 4) Likelihood a mark will be found unenforceable by virtue of having become generic

Adapted from J Cromley, Intellectual Property Valuation Standards, IP Today, January 2007

Benefits of IP reporting for managers and investors

For managers	For investors
Communicate value of IP to investors	Get information on how IP drives growth
Show what IP is owned by the company	Receive adequate inputs for earnings/sales forecasts
Put a value on IP	Better estimate risks/revenues of an investment
Explain how IP relates to business segments	Better understand the nature of a business Increase predictability while decreasing volatility

Adapted from R Ghafele, "Getting a Grip on Accounting and Intellectual Property", at http://www.wipo.int/sme/en/documents/ip_accounting.html

Underlying all three is the same problem for merger theory – in markets that rely on IP and customarily enforce patent rights through threat of litigation, how should the 1992 *Horizontal Merger Guidelines* be applied? The medical and technology markets should contemplate material extension of Hart-Scott-Rodino-like notification obligations in the future. The momentum behind such an extension was demonstrated in the pharmaceutical context with the enactment of the Medicare and Prescription Drug Improvement Act; a second generation of such notice requirements is not difficult to imagine.

The April 2007 joint report issued by the Department of Justice and the FTC, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition*, affirmed the continuing relevance of the framework of analysis articulated in the 1995 *Antitrust-IP Guidelines*. According to the FTC's press release, the report's conclusions include:

- *"Antitrust liability will not attach for mere unilateral, unconditional refusals to license patents;*
- *Conditional refusals to license that cause competitive harm are subject to antitrust scrutiny;*
- *Joint negotiation of licensing terms by standard-setting organisation participants before the standard is set are not per se antitrust violations;*
- *Cross-licenses and patent pools continue to be evaluated under the rule of reason articulated in the 1995 Antitrust-IP Guidelines;*
- *Combining complementary patents within a pool is generally procompetitive;*
- *Rule of reason analysis also applies to IP licensing agreements, including non-assertion clauses, grantbacks, and reach-through royalty agreements;*
- *The Antitrust-IP Guidelines remain effective for tying and bundling*
- *Evaluating practices that extend beyond a patent's expiration begins with whether the patent at issue confers market power (pharmaceutical-generics context)*
- *Collecting royalties beyond a patent's statutory term can be efficient."*

It will be particularly instructive to monitor the application of the new guidelines in the context of a growing body of academic research on antitrust approaches to long-recognised problems in patent settlements, patent hold-up and scope for royalty stacking.

Accounting principles

Intellectual property valuations are often required for M&A accounting, transfer pricing, investment and financing due diligence, litigation and joint ventures. FASB Statement 141 outlines five functional categories of intellectual asset:

- Marketing-related intangible assets including trademarks.
- Artistic-related intangible assets including copyrighted works.
- Customer-related intangible assets including customer lists (can be treated as a trade secret).
- Contract-based intangible assets.
- Technology-based intangible assets including patents and trade secrets.

The American Society of Appraisers (ASA) developed a two-part draft standard comprised of an intangible asset valuation standard and a statement on intellectual property valuation. The intangible asset valuation standard mandates consideration of the bundle of legal rights, protections and limitations pertaining to the subject intangible, as well as remaining economic life and likely economic benefits the intangible asset confers during the asset's life. The intellectual property statement advises general factors to be considered, eg, the feasibility of and character of potential commercial exploitations, as well as more specific factors enumerated for each of the four legal intangibles.

SFAS 157, effective for financial statements issued for fiscal years beginning after 15th November 2007, defines fair value as: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Inputs to the valuation techniques have been segregated into three levels:

- Level 1 (highest priority) inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 inputs are those quoted prices not in Level 1 but that are directly or indirectly observable.
- Level 3 inputs are unobservable inputs that reflect assumptions about what market participants would use in their pricing analyses.

Interestingly, fair value is a market-based selling or exit price. The fair values of assets are measured based on highest and best use by market participants, which will be complicated by the differing business

objectives that characterise patent owners. The application of SFAS 157 to intangible assets and liabilities is entirely speculative.

While the market effects of SFAS 141, 142 and 157 remain largely unknown and subject to speculation, their elaboration will have profound affects on IP-based transactions. Accounting recognition and the possible advent of voluntary IP disclosures supplied in appendices to SEC filings will powerfully shape preferred transaction vehicles and analyst scrutiny of perceived financial health. The approved valuation standards will critically affect the extension of risk capital secured by IP. Two issues bear noting: defining only such IP that has direct revenue streams as intangible assets will drive under-reporting of company IP so long as IP benchmarking does not provide a solution; and the differing treatment of internally generated IP versus acquired IP poses inconsistencies.

Changing market

The economic value of the limited monopoly grant embodied in a US patent relies on the transferability and enforceability of the right. The degree to which two parties compete in a market for an accused product determines whether the legal exposure is principally to the reasonable royalty analysis or also includes a lost profits component. Corporate IP managers and IP investors are naturally focused on reliable and reproducible methods to calculate litigation liability exposure and evaluate corporations' financial and operational resources to manage the liability. This latter evaluation emphasises the fundamental importance of the grounds on which injunctive relief is granted because business alternatives remaining after compliance with the terms of the injunction can be effectively non-existent, distinctly unpalatable or unjustifiably risky.

Perceived value in IP regulates the financing of innovation – the provisioning of risk capital to innovators and their assignees – and depends critically on consistent standards in valuation becoming adopted and broadly respected. A rule of thumb in the Northern District of California is US\$3 million in fees for the first patent in suit and US\$1 million for each additional patent litigated (Quoted in Nance *et al*, "Patent Litigation: Is it worth the Expense?", *Genetic Engineering & Biotechnology News*, 1st April 2006). These fees do not reflect important risks assumed in enforcing patent rights, including: the possible disclosure of confidential information; likely defence against an

assertion of invalidity; economic losses sustained as a direct result of the patent litigation (eg, customer hesitation to deal with companies embroiled in litigation and lender, investor or shareholder aversion); and exposure to a shareholder suit questioning the benefits of litigation where recoveries fail to justify expenses and/or have adverse consequences for the company.

Investors whose investment strategy is based in part on efficiencies achieved through changing the management of target companies' intellectual assets will be particularly attuned to this evolving body of law. The potential returns on enforcement include an excessive award of damages, trebling of damages where wilful infringement is found and longer-term deterrent effects, which increase the value of the subject patent as well as increasing the value of other patents in the enforcement company's estate.

The complex regulation of the IP markets reviewed above suggests the dawn of a new era as reform is implemented broadly across the patent law, antitrust law and accounting regulations. The market is poised to witness the wholesale clearance of the patent underbrush, revealing a less skewed distribution of patent assets, higher patent quality, improved predictability of litigation exposures and returns on investment, and a renaissance of market innovations catering to the burgeoning needs of corporate IP managers, IP investors and IP lenders. As regulatory volatility peaks and marketplace mechanisms become more efficient and easier to use, new and powerful models for the extraction of value in IP assets and IP investment programmes will emerge. ■

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