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PATENT LICENSING ESSENTIALS

Key Issues When Monetizing Your Patents

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LEGAL SOLUTION

Program Agenda

- Patent Ecosystem and Current Challenges and Opportunities
 - Direct Licensing
 - Indirect Licensing
- Scope
 - Covered Assets
 - Field of Use/Restrictions
 - Exclusivity
 - Affiliates
- Royalties/Financial Considerations
- Exhaustion
- Change of Control
- Enforcement and Audit Rights
- Indemnification
- Q & A

Patent Licensing Ecosystem: Challenges and Opportunities

Patent Licensing Ecosystem: Challenges and Opportunities

- Boards of Directors and C-Suite increasingly view patents as ***strategic assets***
- Product convergence in marketplace putting increased pressure on strategic value of IP assets
- Perceived under-exploited value of IP in today's market
- Shareholder activism (e.g., Starboard) and other investors seeking “IP-adjusted Enterprise Value”
- Historical “only for defensive purpose” patent-usage model no longer as dominant
- Building/maintaining global patent portfolios is expensive and a drag on profitability – where is ROI?
- Monetization by operating companies continues
- However:
 - Enforcement and recovery of significant damages becoming more difficult
 - Public IP company valuations dropping, threatening business model

Differing Value Propositions of Patents

- Income/Cash
 - Sales
 - Licensing
- OPEX Savings
 - Patent peace (large portfolio and reputation can deter assertions)
 - Design freedom (some product costs saved)
- Marketplace (Product)
 - Use as trigger for innovation collaboration with third parties
 - Premium pricing
 - Protect (create/maintain) competitive position
- Other
 - Improve bargaining position in context of JV or other transaction
 - Security for debt; securitize income streams

Monetization Continuum

None	Defensive	Monetization			
		Sales	Direct	Indirect (Basic)	Indirect (Other)
<ul style="list-style-type: none"> - Drag on stockholder value - Option value for “maybe some day” will monetize - May need it defensively some day - But, portfolio maintenance costs in OPEX every quarter 	<p>Cross license to offset the cost of using competitors’ IP</p>	<p>Sell patents for cash</p>	<ul style="list-style-type: none"> - Build an in-house team and assert against infringers - Requires investment and commitment 	<ul style="list-style-type: none"> - Have an existing third party NPE assert your IP against infringers - Transfer patent for upfront and/or backend % - Core IP v. Non-core IP: What IP to retain? 	<ul style="list-style-type: none"> - Establish a friendly NPE <ul style="list-style-type: none"> ○ Using your existing patents, and/or ○ Using third party patents that you infringe, and/or ○ Using newly acquired patents - Target competitors (privateering) <ul style="list-style-type: none"> ○ Strategic or financial? ○ Antitrust concerns

Implementing Patent Licensing Programs

Addressable Market

- Infringing products
- Overall size, growth rate, market shares

Portfolio Coverage

- Geographic jurisdiction
- Strength
- Encumbrances
- Life of patents
- Entire Market Value rule
- *Georgia Pacific* factors
- Standards Essential Patents

Value/Price Model

- Negotiated license agreement vs.
- Litigated settlement

Public company valuation

- Annual revenue & growth rate
- Net margin (%)
- Comparable company P/Es

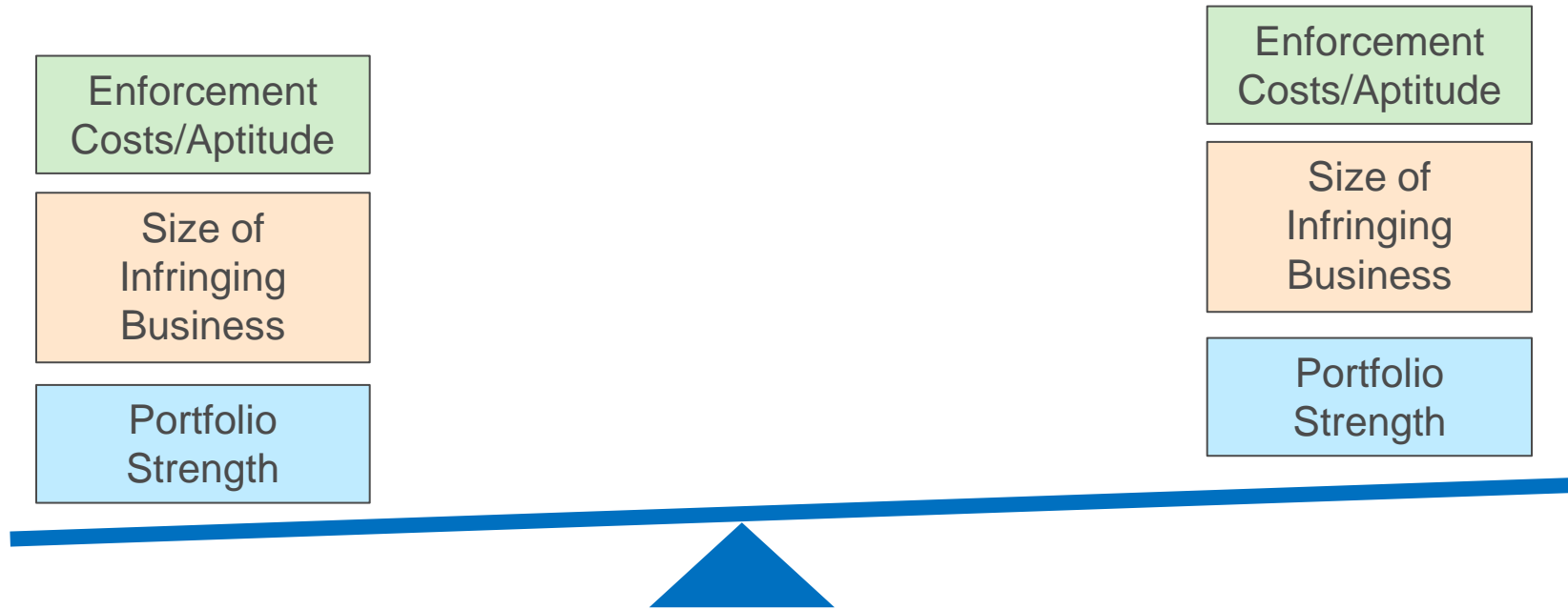
Financial Model

- License duration
- Technical, sales and legal resources needed
- Litigation “war chest”

Private company valuation

- Annual revenue & growth rate
- EBITDA margin (%)
- After-tax free cash flows
- DCF and/or EBITDA multiples

Patent Licensing – Asymmetry Is Key



Who pays and how much is a function of the relative weight of these factors (imbalance of exposure)

Direct Licensing

Leveraging IP – Direct Licensing Programs

- Not for the faint of heart
- Requires commitment to enforcement
- Sustained year to year licensing revenue often receives higher valuation multiples on share price than product revenue
- Asymmetry is critical
- Certain considerations
 - License core or non-core IP?
 - Sustainable “product development pipeline”?
 - Are customers or suppliers significant proportion of addressable market?
 - Multi-tier portfolio licensing (can you avoid exhaustion)?
 - Risk of patent infringement counterclaims?

Building Blocks of a Direct Licensing Program

- Define purpose of the program
- Evaluate strength of portfolio for monetization
- Financial modeling
- Evaluate execution and other risks
- Evaluate staffing requirements (legal, business development/sales, finance/controller support) and corporate structural options (e.g., moving portfolio/patents for venue or tax reasons, to avoid existing cross-license encumbrances)
- Manage cultural differences between traditional legal function and IP revenue-driven business function
- Product (patent) development and acquisition
- Enforcement options
- Building executive and Board alignment – and commitment

Direct Licensing – Evaluation Phase

- Quality and strength of the portfolio
- Validity issues/prior art
- Discernment issues
- Reverse engineering/evidence of use charts
- Potential claim construction issues
- Enforceability (inequitable conduct defenses, other)
- Existing encumbrances (prior licenses, university or gov't funding)
- Addressable technology/company market
 - Choices when customers or suppliers infringe
- Pricing (damages) model

Financial Assessment

- Determine addressable market
- Evaluate asymmetry of portfolio and of revenues
- Model royalty base and various rates applied to total addressable market
 - Effect if patents are FRAND encumbered
- Assume various per-license durations, e.g., 3-10 years (if guillotine)
- Apply a discount rate for risk adjustment
- Determine NPV
- Benchmark against damages estimates
 - Include “Entire Market Value” v. “Smallest Saleable Unit” considerations re damages where patents cover components
- Review with
 - Company Controller regarding revenue recognition
 - Tax

Indirect Licensing

Leveraging IP – Indirect Licensing

- Operating companies looking to Indirect Licensing models
 - Sell (or exclusively license) patent lots to one or more NPEs for monetization
 - Various other models
- Easier decision – allows for partial commitment, arguably allows for deniability
- Theoretically eliminates risk of cross-claims of patent infringement
- But, also eliminates likelihood of securing a cross license (important to some)
- Lower ROI
- Still requires internal analyses, but smaller resource commitment
- Numerous business (and pricing) models
- Maximizes flexibility and optionality

Indirect Licensing – Frequent Deal Issues

- Financial Issues
 - Backend participation for licensor and allocation of enforcement operating expenses are commonly negotiated points
- Field(s) of Use
- Clawbacks
- Representations and Warranties
- HSR Filing Requirements Possible
- Degree of After-Transfer Control / Involvement; Mitigation of Risk
 - Target specification; licensee approval; pricing approval
 - Holdback of springing sublicense rights
 - Performance metrics (with or without claw-back rights)
 - Effect of termination – reversionary rights and effect on then-existing litigation
 - Security interest; restrictions against senior lien from, e.g., debt
 - Restrictions on licensing, sale, etc. of patent assets
 - Bankruptcy risk

Indirect Licensing – Possible Standing Issues

- Structure and degree of after-transfer control can impact grantee's standing to bring a patent enforcement suit and make grantor a necessary party
- Grantor must transfer “all substantial rights” in patent or grantee may lack enforcement standing. Courts look at agreement as whole.
 - “Even if a patentee does not transfer legal title, it may transfer significant rights to the patent. When the patentee transfers rights, the party that has been granted all substantial rights under the patent is considered the owner regardless of how the parties characterize the transaction that conveyed those rights.” *Azure Networks, LLC v. CSR PLC*, 771 F.3d 1336 (Fed. Cir. 2014)) cert. granted, judgment vacated, No. 14-976, 2015 WL 582818 (U.S. Apr. 20, 2015).
- Different terms are associated with different risks regarding standing:
 - *Lower risk*: Requiring transferee to maintain patents; Limited “no fly” list
 - *Medium risk*: Reversionary interest; Retention of rights to profits
 - *Higher risk*: Transferor controls patent prosecution/maintenance; Further assignment requires transferor's consent; Security Interest

Summary of Pros and Cons of Direct v. Indirect Monetization Licensing

Monetization Approaches – Tradeoffs

	Pros	Cons
Pure Sales	<ul style="list-style-type: none"> • Fastest time to money • Low burden on management 	<ul style="list-style-type: none"> • Not recognizable as operating income • Permanent loss of asset
Direct Licensing	<ul style="list-style-type: none"> • Highest ROI • Potential high impact on share valuation • Maximum control (strategy, targets, price) • Ability to get a cross-license back 	<ul style="list-style-type: none"> • Highest expense (and management time) • Retaliatory infringement counterclaims • Longer “time to money” • Potential conflict with product business • May have to establish the market via initial litigation
Indirect Licensing	<ul style="list-style-type: none"> • Relatively faster time to money • Reduces OPEX burdens • Lower burden on management time • Infringement “counterclaims” less likely • “Deniability” vis-à-vis targets • NPE pricing negotiable within ranges (gross v. net models) 	<ul style="list-style-type: none"> • Significantly lower ROI than Direct model • Loss of asset unless clawed back • Little or no control over targets and pricing • No cross-license back • Potential standing issues if attempt too much control

Deal Issues

Scope – Whether Licensor or Licensee

- Segmentation of portfolio: portfolio-wide or by groups of patents
- Almost always non-exclusive
- Geographic scope: Worldwide or by jurisdiction/region
- Field of use
- Guillotine (e.g., 5 year term) v. life of patent (if latter, also capture period)
- Cross-license
- Patent laundering/foundry
- Definition of “Affiliates”

Royalties/Financial Considerations

- Worldwide sales or limited to countries in which licensor has existing patents
- Fixed fee v. running royalty v. per unit dollar amount
- Floors and caps
- Revenue recognition
- MFNs
- FRAND considerations

Exhaustion

Overview of Current Law on Exhaustion

- Exhaustion is a defense to patent infringement resulting from authorization *implied* by an authorized **sale** of an embodiment of a patented invention
 - A sale is authorized if it is pursuant to an express or implied license, or a covenant not to sue
 - Implied licenses can be disclaimed, as the intent of the parties controls; patent exhaustion cannot
 - *Mallinkrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992), which held that a sale that is properly conditioned may not “exhaust” the patentee’s rights in the embodiment, may no longer be good law
- Current Case Law
 - *U.S. v. Univis Lens Co.*, 316 U.S. 241 (1942) – authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold
 - *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617 (2008) – patent exhaustion doctrine applies to both product and method claims
 - *TransCore, LP v. ETC Corp.*, 563 F.3d 1271 (Fed. Cir. 2009) – authorized sale pursuant to a covenant not to sue will result in patent exhaustion (i.e., same as a license)
 - *Keurig, Inc. v. Sturm Foods, Inc.*, 732 F.3d 1370 (Fed. Cir. 2013) – patent exhaustion occurs on a patent-by-patent basis (as opposed to a claim-by-claim basis)

Overview of Exhaustion (cont'd)

- Restrictions on Licenses
 - Unrestricted license to “make, use and sell products under the licensed patents” will result in exhaustion (i.e. LGE’s license to Intel)
 - Restricted license to “make use and sell products under the licensed patent *for non-commercial uses*” are preferable
 - LGE may have succeeded had it included in its license grant a provision restricting Intel to selling products to LGE’s licensees
 - License restrictions should be explicit and unequivocal
- Practical Considerations re: *Keurig*
 - Granting licenses to multiple tiers within the supply chain (e.g., supplier, distributor, customer) may be difficult or impossible
 - Companies may modify their patent prosecution strategy in the US, opting for more patent applications and may seek divisional or continuation reissue patents for patents that have already issued (see MPEP 1451)

International Patent Exhaustion

- *Jazz Photo Corp. v. ITC* (Fed. Cir. 2001) – **US patent rights** are not exhausted by **foreign** sales
- Due to *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S.Ct. 1351 (2012), which extended the copyright first sale doctrine to apply to international sales, many commentators and courts have questioned whether patent exhaustion should apply to international sales.
- Post-*Quanta*, some district courts have found that exhaustion occurred from foreign sales
 - *LG Electronics, Inc. v. Hitachi, Ltd.*, 655 F. Supp. 2d 1036 (N.D. Cal. 2009)
 - *Multimedia Patent Trust v. Apple Inc.*, 2012 U.S. Dist. LEXIS 167479 (S.D. Cal. 2012)
 - *SanDisk Corp. v. Round Rock Research LLC*, 2014 WL 2700583 (N.D. Cal. June 13, 2014) (unreported)

International Patent Exhaustion (cont'd)

- On April 14, 2015, the Federal Circuit, *sua sponte*, ordered *Lexmark Int'l, Inc. v. Impression Products, Inc.* to be heard *en banc* and required the parties to brief the following issues:
 - The case involves certain sales, made abroad, of articles patented in the United States. In light of *Kirtsaeng*, should the Federal Circuit **overrule *Jazz Photo***, to the extent it ruled that a sale of a patented item outside the United States never gives rise to United States patent exhaustion?
 - The case involves (i) sales of patented articles to end users under a restriction that they use the articles once and then return them and (ii) sales of the same patented articles to resellers under a restriction that resales take place under the single-use-and-return restriction. Do any of those sales give rise to patent exhaustion? In light of *Quanta v. LG*, should this court **overrule *Mallinckrodt***, to the extent it ruled that a sale of a patented article, when the sale is made under a restriction that is otherwise lawful and within the scope of the patent grant, does not give rise to patent exhaustion?

Additional Considerations

Change of Control

- Transferability upon a merger or change in control (often a pricing issue)
 - May limit licensee's and its Affiliates' ability to engage in M&A activity in the future
- Protecting against upstream post-acquisition de facto license
 - Limit by product line
 - Limit by CAGR
- Subdivision of rights upon sale of a product line or business unit (i.e., partial assignment)
- Any post-termination rights if license terminates upon a Change of Control?
- What happens when one licensee acquires another licensee – which license governs?

Enforcement – Challenges to Monetization

- The presumption that patents are valid has been eroded:
 - Recent changes in interpretation of Section 101 and the adoption of *inter partes* review (“IPR”) procedures have greatly increased the likelihood that a patent will be found invalid.
 - Even if a patent is found valid, potential licensees may prefer to argue invalidity before settlement. Many courts will issue stays pending IPR, increasing the time it takes to monetize the patents.
- Federal Circuit decisions, such as *Ericsson Inc. v. D-Link Sys., Inc.*, 773 F.3d 1201 (Fed. Cir. 2014), continue trend away from damage awards based on end-unit pricing and towards the use of the smallest salable unit as a royalty base.
 - For patents on chipsets that are used in phones, this can be the difference between a \$20 royalty base and a \$400 royalty base.
- Changes in attorney fee awards change the calculus for Defendants when determining whether to fight or settle.

Audit Rights

- Often ignored boilerplate
- Can result in a “lawsuit within a lawsuit”
- Be careful about subjecting audit rights to any ADR process generally set forth in the license
- Be careful about how a qualified auditor is defined
 - Vagueness and danger of typical phrase “independent”
 - Big 5 accounting firm v. CPA
- Define a tight process (timing) of audit

A Word About Standard Essential Patents

- Standard Essential Patents (“SEPs”) are patents that a company has committed to a standards setting organization and that have become part of a technical standard widely adopted in particular technologies (and thus products)
- SEPs are subject to various limitations
 - Must be licensed at FRAND (fair, reasonable and non-discriminatory royalty rates)
 - Increasingly difficult to obtain injunctions in court (and potentially exclusion orders at the U.S. International Trade Commission) thereby eliminating a leverage point
- U.S. Courts have held that, when determining royalty rates for SEP patents, “the patented feature must be apportioned from all of the unpatented features reflected in the standard. Second, the patentee's royalty must be premised on the value of the patented feature, not any value added by the standard's adoption of the patented technology.” *Ericsson Inc.*, 773 F.3d at 1232.
- The China National Development and Reform Commission (NDRC) issued Administrative Penalty Decision No. 1 finding Qualcomm guilty of violating China Antitrust Law for its licensing of SEPs. A remediation plan, among other requirements:
 - Requires Qualcomm to license SEPs and non-SEPs separately in China “without justifiable cause” (i.e., no bundling or tying)
 - Requires SEPs in China to be licensed at 65% of net-sales price
- This area of the law is rapidly changing and may result in “balkanization” of patent licenses and monetization strategies

Appendix 1

Patent Sales Chart — Representative Patent Sales (Part 1 of 3)

Year	Buyer	Seller	Patents	Price	Per Patent Avg.
2014	RPX	Rockstar ¹	4,000+	\$900M	\$225K
	Twitter	IBM ²	900+	\$36M	\$40K
	Qualcomm	Hewlett-Packard ³	2,400	?	
	Lenovo	Unwired Planet ⁴	2,500	\$100M	\$40K
	Inventergy	Panasonic ⁵	500	?	
	Intellectual Ventures	various parties ⁶	200+	?	\$1-2M
	Spherix Incorporated	Rockstar Consortium ⁷	100	?	

Patent Sales Chart — Representative Patent Sales (Part 2 of 3)

Year	Buyer	Seller	Patents	Price	Per Patent Avg.
2013	FLIR Systems	Tessera ⁸	200+	\$14.9M	\$74K
	Spherix	Rockstar Consortium ⁹	7	\$3M	\$286K
	Hudson Bay Capital	Orckit Comm'ns ¹⁰	76	\$5M	\$66K
	Network-1 Technologies	Mirror Worlds ¹¹	14	\$3M	\$214K
	Marathon Patent Group	CyberFone Systems ¹²	38	\$3.3M [?]	\$87K
	Funai Electric	Lexmark ¹³	1,500	\$73.5M [?]	\$49K
	Pendrell	Nokia ¹⁴	125	\$2M [?]	\$16K
	Network-1 Technologies	Ingemar Cox (inventor) ¹⁵	5	\$1M	\$200K
	IV/RPX	Kodak ¹⁶	1,100	\$527M	\$479K
	AST	MIPS ¹⁷	498	\$350M	\$703K

Patent Sales Chart — Representative Patent Sales (Part 3 of 3)

Year	Buyer	Seller	Patents	Price	Per Patent Avg.
2012	Facebook	Microsoft	650	\$550M	\$846K
	Microsoft	AOL ¹⁸	800	\$1.056B	\$1.32M
	Intel	Real Networks	360	\$120M	\$333K
	Intel	InterDigital	1,700	\$375M	\$220K
	Apple	Rockstar	1,024	?	
2011	Acacia	Adaptix	230	\$160M	\$696K
	Tessera	MoSys	73	\$35M	\$479K
	Google	MOSAID	18	\$11M	\$611K
	Rockstar	Nortel	6,150	\$4.5B	\$732K
	HTC	ADC Telecomm'ns ¹⁹	96	\$75	\$915K
	HTC	S3 Graphics	235	\$300M	\$1.28M
	Consortium	Novell	882	\$450M	\$510K
2010	HTC	ADC Telecom	96	\$75M	\$781K
	Facebook	Friendster	18	\$40M	\$2.22M

Patent Sales Chart – Endnotes

1. RPX purchased more than 4,000 telecommunications patent assets from Rockstar for \$900 million on December 23, 2014.
2. Twitter purchased 900 patent assets from IBM on January 31, 2014.
3. Qualcomm acquired 2,400 patent assets from Hewlett-Packard in a quiet deal in which the purchase price was not publicly announced.
4. Lenovo purchased 2,500 patent assets (21 patent families) from Unwired Planet for \$100 million.
5. On January 6, 2014, Inventergy Inc. acquired 500 patent assets from Panasonic Corporation.
6. Intellectual Ventures acquired over 200 patent assets throughout 2014 and paid an average of 1-2 million.
7. Spherix Incorporated acquired over 100 patent assets from Rockstar Consortium.
8. \$14.9 million was the purchase price for a substantial portion of the micro-optics business of Tessera, which reportedly included over 200 patent assets.
9. Consideration was a combination of (a) \$2 million in cash, (b) \$1 million in securities, subject to a Lockup Agreement (see note 3 above), and (c) a back-end revenue share from any resulting monetization. Spherix Inc. Form 10-Q, November 14, 2013.
10. Orckit entered into a Strategic Investment Agreement with Networks3, Inc., an NPE controlled by Hudson Bay Capital Management, pursuant to which Networks3 paid Orckit \$5 million for the purchase of Orckit's patent portfolio. In addition, Orckit received common stock of Networks3 constituting 10% of its outstanding capital stock (after giving effect to the issuance thereof) and a back-end profit share from any resulting monetization of the patents. Orckit's participation percentage starts at 25% of aggregate profits in excess of \$7.5 million and will decrease in steps down to 5% of profits in excess of \$250 million. Orckit Communications Ltd. Form 6-K, March 13, 2013.

Patent Sales Chart – Endnotes (cont'd)

11. The Mirror Worlds patent portfolio consisted of 9 issued US patents and 5 pending US applications. The consideration paid by Network-1 to Mirror Worlds, LLC consisted of (a) \$3 million in cash, (b) 5-year warrants to purchase 875,000 shares of common stock of Network-1 at \$1.40 per share, and (c) 5-year warrants to purchase 875,000 shares of Network-1 at \$2.10 per share.
12. The CyberFone portfolio consisted of 10 US patents, 27 foreign counterparts and 1 pending application. Marathon Patent Group is being advised by IPNav.
13. Funai purchased for approximately \$100 million, in addition to the patent assets, Lexmark's inkjet-related research and development assets and tools, all outstanding shares and the manufacturing facility of Lexmark International (Philippines), Inc., and other inkjet-related technologies and assets.
14. 81 of these patents were identified by Nokia as Standard-Essential.
15. The acquisition consisted of 4 US patents and 1 pending US application. Network-1 has since filed 7 additional patent applications with the USPTO based on the acquired technology. The consideration paid to Dr. Cox was a combination of (a) \$1 million in cash, (b) 403,226 shares of common stock and (c) 12.5% of the net proceeds resulting from Network-1's monetization efforts of the acquired patents. Network-1 Technologies, Inc. Form 424B3, November 14, 2013.
16. A portion of the \$527 million was paid by 12 intellectual property licensees organized by IV and RPX Corporation—including Google, Apple, BlackBerry, Facebook, Amazon and Microsoft. Another portion was paid by IV, which acquired a substantial majority of the digital imaging patent portfolio subject to these new licenses.
17. MIPS retained 82 patent assets and granted AST a license under these retained patent assets.
18. Microsoft acquired over 800 of AOL's patent assets and a non-exclusive license under AOL's retained patent assets. AOL Inc. Form 8-K, June 15, 2012.
19. The acquisition consisted of 82 issued patents and 14 pending applications. Of the total consideration, \$7.5 million is due in April 2014, three year after the closing.

Relevant Practical Law Resources Available With a *Free Trial* to Practical Law

- Practice Note, Patent License Agreements
- Practice Note, IP Licenses: Restrictions on Assignment and Change of Control
- Standard Document, Patent and Know-how License Agreement (Pro-licensor)
- Patent License Checklist
- Article, Patent Monetization and Valuation

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Questions