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Feature

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Monetizing IP: Variables Impacting the Value of IP Assets

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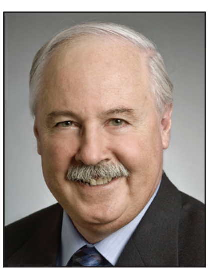

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Editor's Note: *This is the first installment in a series of articles on various aspects of intellectual property. For more information on this topic, visit ABI's Technology and Intellectual Property Committee website at committees.abi.org.*

Many bankrupt tech companies have intellectual property (IP) portfolios that offer greater value in a sale than as part of a distressed entity's going-concern value. As a result, bankruptcy practices involving IP sales have become increasingly common and increasingly aggressive. The IP sale price in a bankruptcy sale may far exceed the present value of a revenue stream from conventional IP licensing revenue. Quick patent sales or licensing for cash are generally more appealing to creditors than holding equity in a reorganized company, even if the debtor retains valuable IP in its reorganized business. Holding reorganized debtor equity involves certain risks and volatility for creditors, which claim trader creditors in particular often will not tolerate. With such traders insisting on maximum recoveries from purchased claims, and in light of often unimpressive (from the perspective of key creditors) management teams,[1] distressed tech debtors are often forced into total (*e.g.*, the patent sale in the Nortel bankruptcy case) or substantial (*e.g.*, the patent sale in Kodak's bankruptcy case) asset sales centered around IP.[2]

While IP can be sold to "trolls"[3] or "anti-trolls,"[4] those deals often do not include full IP packages because trolls (and anti-trolls) tend to concentrate on patents alone. Even as to patents, IP licensees often have difficulties obtaining third-party licensor consents, especially for trolls as successors or assignees, and license interests are less attractive to trolls since the licensee litigation position is less powerful than ownership. For example, Kodak's recent patent portfolio sale included primarily owned patents without Kodak attempting to force the assumption and assignment of its licensee interests.[5]

More importantly, a distressed owner of valuable IP often has trouble monetizing that IP outside of bankruptcy, inspiring more pressure to use the bankruptcy process as a solution.[6] While there are many variables and concerns, consider the following three items:

1. Acquirers of the distressed debtor's assets outside of bankruptcy worry about fraudulent transfers if the IP owner files for bankruptcy after the sale. It is too easy for a bankrupt IP owner (or its creditors' committee or reorganization plan liquidating trustee) to allege with real or exaggerated appraisals that the buyer failed to

1 While the bankruptcy restructuring process includes new chief restructuring officers and sophisticated restructuring professionals, it is often a hard to convince strategic creditors to trust the same core management whose actions made the bankruptcies necessary. Selling IP can simply be more attractive and far less risky in certain cases.

2 While many outsiders mistake the meaning of Kodak's inability to achieve the high IP pricing initially projected by some professionals based on its Nortel IP sale model, the real IP players knew that Nortel was the aberration and that Kodak was unlikely to convince the bidders to overpay. Experienced players predictably discounted for the kinds of issues we will discuss in a subsequent installment of this article. Nevertheless, between the Nortel and Kodak bookends on the value continuum is a reality of value for IP that can be unlocked in a monetization strategy.

3 That is, "nonpracticing entities" who buy patents and other IP to profit solely from litigation.

4 That is, patent aggregators competing with trolls for tech company users of the IP.

5 The Nortel and Kodak sales also illustrate how purchaser alliances can increase their collective purchase price. The "troll value" of a powerful patent tends to exceed what a strategic business could afford to pay for it, since there is often a significant group of alleged infringers who, when threatened, are willing to bid at least the cost of defense for a settlement. That price can exceed the commercial value of a license to a single licensee who merely uses the patents in its business. Of course, those same licensees can form their own bidding group (with or without an anti-troll aggregator) to outbid the troll, achieving greater benefits without "feeding the beast."

6 Bankruptcy provides more certainty and safety for buyers, as well as the chance to persuade the debtor-seller and its creditors committee to help enhance the IP value with both traditional bankruptcy powers (*e.g.*, fair uses of §§ 363(f), 365, 544, 548, 550, 502(d), 105, 362, 506(c), 502(c), 502(d), etc.) and more aggressive bankruptcy powers, especially those licensees and other contract counterparties who are unwary or inattentive and fail to make timely objections that could have blocked the impairment or stripping of their rights in the debtor's bankruptcy maneuvers.

pay reasonably equivalent value to the distressed seller under 11 U.S.C. §§ 548 or 544 and 550.[7]

2. Licensees fear the increasingly popular sequence of arguments attempting to enhance sales prices for the patents, such as the sale purporting to be free and clear of liens, claims and interests defined too broadly under 11 U.S.C. § 363(f),[8] including attempts to eliminate § 365(n) and other defenses of the licensees,[9] and by purporting to terminate the IP licenses by a § 365 rejection so that the buyer can sue them as infringers.[10]

3. New and old licensors to the distressed debtor approached before its bankruptcy are reluctant to trust their fate to the bankruptcy process, fearing that anti-assignment and change-in-control provisions in their licenses will be evaded in the licensee's bankruptcy, despite the nondebtor licensor's conviction that § 365(c)(1) applies to overcome § 365(f) under circumstances that vary from circuit to circuit and court to court.[11]

Issues to Consider in Evaluating IP

The goal of the IP buyer is to pay appropriately for the value that is capable of being realized for that buyer's expected use of that IP.[12] A sophisticated strategic buyer of tech company assets must evaluate the value of the package of IP, which includes evaluating the "IP gaps" that occur when a complex product or service is being marketed in reliance on that IP package. Should any vulnerable part of the IP become impaired or lost, the price drops, whether, for example, because (1) a third-party IP license into the subject company cannot be effectively assigned to the buyer; (2) an IP license into the subject company from a distressed or bankrupt licensor is at risk of that licensor's rejection under § 365 or from a sale free and clear order pursuant to § 363(f) and (m), despite the merits of the subject company-licensee's § 365(n), *Sunbeam* or other arguments; or (3) because the IP is invalidated or impaired by litigation. Before evaluating the IP gaps, one needs to appreciate the strengths and weaknesses of the IP rights themselves in the package.

"Intellectual property" is defined so narrowly in § 101(35A) of the Bankruptcy Code that it is only useful for limiting the debatable scope of 11 U.S.C. § 365(n) for protecting licenses from the consequences of rejection under § 365 in the IP licensor's bankruptcy. The normal usage of the intellectual property that we call "IP" in this commentary at its broadest boundaries includes patents, copyrights, brand names, trademarks, logos, trade dress, rights of personality or characters, trade secrets and know-how to get "things done," domain names and many exotica (*e.g.*, mask works, meta knowledge, etc.).[13] IP also includes many additions or enhancements thereto in ways somewhat unique to each type of IP (*e.g.*, improvements for improvement patents, derivative work copyrights for upgrades of software, etc.). Indeed, each type of IP has its own unique strengths, weaknesses, specialized practices, remedies and forms of documentation, as well as offensive and defensive legal characteristics, which often cause confusion among nonspecialists and courts, who tend to overgeneralize about IP as if it were one common type of asset class with common rules (*e.g.,* like securities, which can take many unique forms, but share many common legal remedies, liabilities and enforcement principles).[14] The reality, however, is that serious problems can arise from exporting (incorrectly) rules from one type of IP to another type. For example, the concept of an "exclusive license" in copyright law involves different rights and obligations than an "exclusive license" means to patents or any other kind of IP, which is one reason in IP disputes in bankruptcy that nondebtor parties are increasingly seeking withdrawal of the reference to district courts, which may have more IP experience.

In monetizing IP, the owner may use some of the IP for its own goods and services while licensing to others for royalties other IP or other fields of use or other geographic territories. Licensing customers and suppliers can also be valuable in establishing or maintaining a control position in a value chain. If the IP position is strong enough, groups of companies with common or collaborating commercial interests can be formed and licensed so that the overall market can grow while maximizing benefits to the asset owner. Value is also increased if the potential buyer or licensee is able to retain the services of the developers/engineers that have been involved in the creation and continuation of the IP.

Product and market risk can also be shifted or allocated through a license agreement. This is commonly done, for example, in trademark licensing, in which the owner may lack the funding, ability or risk profile to exploit a particular market. The licensee then assumes much of the market risk,

7 Like other unique assets that have not been fully tested in the market, expert valuations can be wildly divergent. For example, compare the $2.3 billion initial Kodak valuation of its portfolio to the $500 million DIP loan value threshold, or consider the final Nortel auction price, which was four times the initial stalking-horse bid.

8 Nondebtor licensees should be able to block prejudicial sales free and clear of their licenses and defenses because of the licensees' rights to adequate protection under §§ 363(e) and 361 and the nonsatisfaction of any other § 363(f) requirements or arguable mootness under § 363(m). However, debtor licensors keep trying aggressive legal theories because they are tempted to try to expand § 363(f) and (m) and because a significant number of inattentive licensees fail to timely object and thereby become easy targets for the buyers' infringement suits that they could have avoided. Timely objections are essential to preserve those licensee rights and defenses in this "scream or die" proc-ess. *See, e.g., Futuresource LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002).

9 Licensees continue to object to any attempt to scrape off their defenses, including those from § 365(n), or where § 365(n) does not apply to a gap (*e.g.*, trademarks and maybe foreign patents or foreign copyrights) under *Sunbeam* (discussed below). Nevertheless, licensor debtors keep trying to sell free and clear of everything by excessively expanding § 363(f) "interests" that they contend can be eliminated for some unallocated and illusory share of sale proceeds as alleged adequate protection under § 363(e).

10 A line of cases, beginning with *Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985), the case that inspired the § 365(n) reform to increase the licensee protections stripped by that criticized decision, and culminating in *In re Interstate Batteries Corp.*, 690 F.3d 1069 (8th Cir. 2012), consider a § 365 rejection of an IP license to be a termination of the contract (subject to a somewhat narrow set of "intellectual property" protected by § 365(n)). That reasoning has always been criticized by nondebtor IP players as a judicial error because, among other things, § 365 rejection of all other kinds of contracts is merely a breach—not a termination—and there is no principled basis for treating IP licenses differently. Those aforementioned termination cases have been refuted by *Sunbeam Prodss Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012), following the analysis of Judge Ambro in *In re Exide Tech.*, 607 F.3d 957 (3d. Cir. 2010), which preserves the licensee defenses based on the license that is not terminated by rejection, but that instead is only a licensor-debtor breach that leaves the licensee with all of its defenses.

11 *Compare, e.g.*, the "hypothetical test" jurisdictions illustrated by *In re Sunterra*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entm't*, 165 F.3d 747 (9th Cir. 1999); and *In re James Cable Partners*, 27 F.3d 534 (11th Cir. 1994) *with, e.g., Summit Inv. & Dev. Corp. v. Mirant Corp.*, 69 F.3d 608 (1st Cir. 1995); *Inst. Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), and other cases addressed by the Supreme Court in noting, but not resolving, these Circuit conflicts in *NCP Mktg. Group v. BG Star Prods.*, 129 S.Ct. 1577 (2009).

12 For example, a buyer intending to litigate with purchased patents tends to focus on somewhat different qualities and aspects of the patents, compared to a strategic user for whom those patents are part of a working IP package merely used to discourage competitors.

13 For our purposes, the broadest definition of IP applies because, regardless of the differences among various types of IP as to their legal character or enforcement remedies, buyers or licensors will pay for and evaluate all such IP. For example, although the law protects trade secrets but does little for mere "know how," the buyer insists on both because both have value, even though know-how is less protected by the law than trade secrets.

14 Even when different types of a common IP category are governed by the same general IP statute, as with trademarks, logos and trade dress (*e.g.*, distinctive packaging), all being types of trademarks, the law adapts to each specialized subcategory.

which can be reduced through use of the IP. In this way, the transaction benefits both parties, with the majority of the financial risk typically on the licensee.

Intellectual property of nearly every sort is an intangible asset often valued at zero for financial reporting, reflecting marginal value costs or the acquisition price for purchased assets. As with any other asset, IP has a range of returns, as well as variability in those returns (investment risk). Further, IP assets have a finite lifespan and must be depreciated over that life in financial reporting. At times, we can think of IP as somewhat like fruit: We wish to grow or acquire it while it is still green, hold it until it is fully ripe when we consume it, and minimize the amount of overripe or rotten fruit we have to discard. Generally, most IP is never worth more than it is right now—just like fruit. However, if we bake it into a pie or blend it into a smoothie, we can at times give the IP new life or it can extend the marketable life and enhance the value. Think of implementations, commercial agreements, trademark usage, and so on as the pie crust or vanilla ice cream we can bundle with our overripe fruit to capture value.

What's more, some types of IP carry their own costs, such as "patent maintenance fees." For U.S. patents, these fees are due at 3 ($1,150), 7 ($2,900) and 11 ($4,810) years after issue date. Since patents may take three years or so to issue, by the time these maintenance fees come due, the holder should be able to make reasonable business decisions about the value of the patent and whether or not the net present value is greater than the maintenance fees going forward. In many cases, the fees are small enough that patents are maintained. (It is possible to revive a patent with expired maintenance fees, but this can be very problematic.) However, for large portfolios, maintenance fees can represent a significant expense (at an average of $443/year for 20 years, a portfolio of 10,000 patents could easily be paying more than $4 million a year in maintenance fees). Therefore, it is prudent for the owner to regularly perform some type of analysis on value of the portfolio and relative to the associated maintenance costs. Many portfolio owners use strategic licensing for extraneous fields of use to cover the carrying costs of the portfolio for its preferred uses.

Conclusion: A Critical Asset

IP is a critical asset class for many companies, especially those that rely on technology (*e.g.,* patent) or brand (*e.g.,* trademark), as well as many other powers, both from a value and strategic perspective. Therefore, such companies should develop IP strategies, both offensive and defensive, including how best to "mine" for IP and then to monetize it, especially in the bankruptcy context. Some companies are successful at developing IP, but surprisingly poor at defending or monetizing it. There are many "tricks of the trade" for every aspect of each process and for every type of IP.

Because of the many problems and opportunities associated with licensing IP, special attention must be given to IP licensing strategies and bankruptcy considerations. IP is the soul of many companies and must be protected and thoroughly considered in each product and corporate expansion. These dynamics, and in-depth concepts on IP monetization, are the subject of the next installment. abi

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