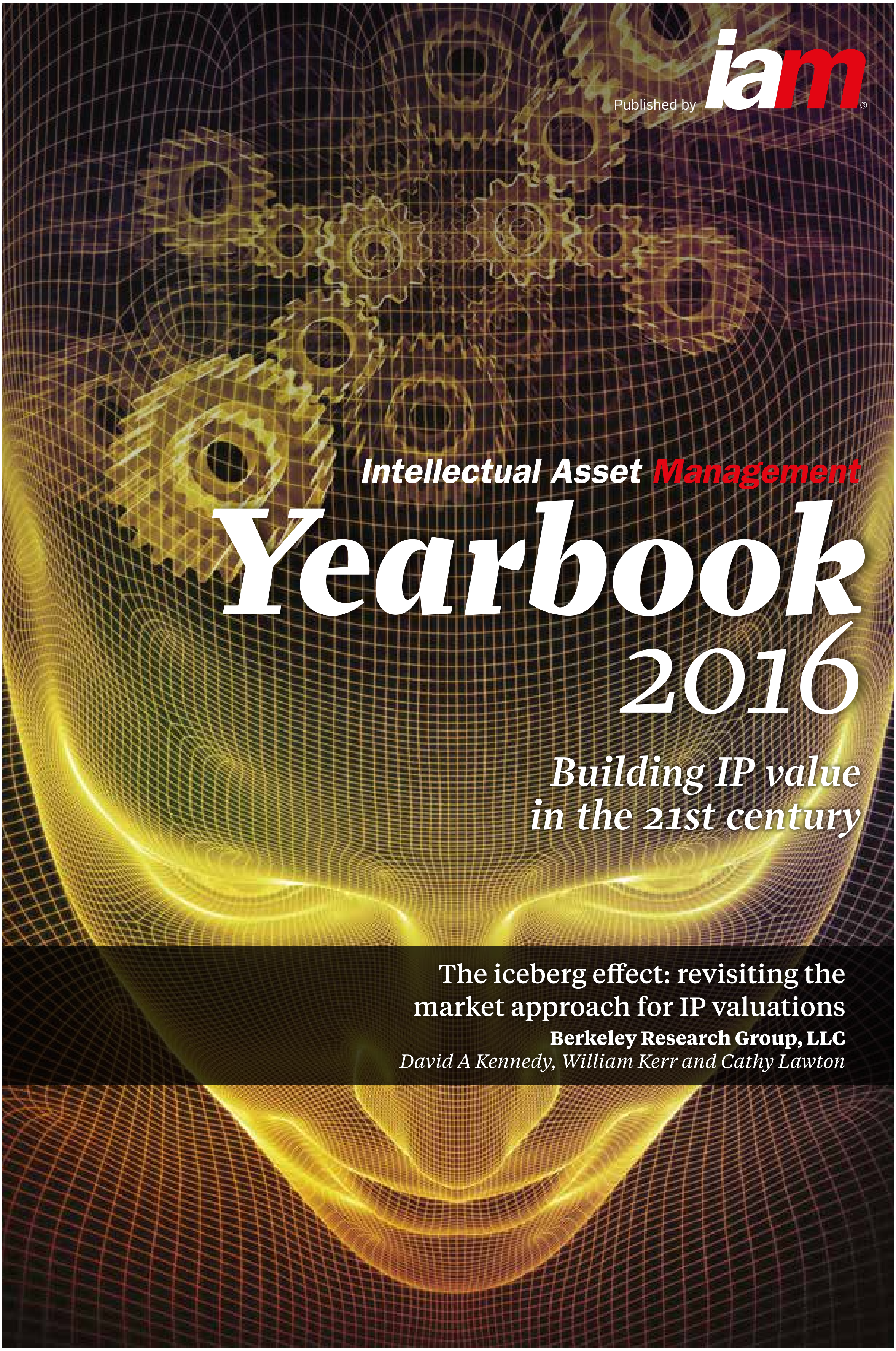

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The iceberg effect: revisiting the market approach for IP valuations

Berkeley Research Group, LLC

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The iceberg effect: revisiting the market approach for IP valuations

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The market approach – along with its analysis of closely comparable transactions – has long been a pillar of IP valuation. However, finding closely comparable transactions in the IP world is difficult – sometimes impossible – because individual IP assets tend to be unique by definition.

Fully understanding the equalised economic comparability of IP licensing deals involves considering much more than the written agreements, which are often the culmination of years of strategic negotiation or litigation and can also be influenced by other market conditions. Further, the relationship between parties has always affected the economics of IP deals (eg, is the licensee a competitor, a customer or both?).

However, that is not all. Significant changes in pending regulatory and judicial reforms over the last few years have added layers of complexity to the analysis of comparability, beyond other significant changes in the IP marketplace. In many cases, the words in the licence agreement are just the tip of the iceberg and do not represent the true value of the intellectual property without significant adjustments for other factors – and the water surrounding these other details can be murky at best.

The 'iceberg effect' in comparable transactions is a relatively easy concept to understand, but it can be difficult to assess fully – especially considering the growing regulatory and legislative changes in the IP marketplace. Like the underwater portion of an iceberg, some valuation factors that cannot be seen on the surface of comparable transactions may materially affect the true value of the deal.

Recent global developments

Recent global developments and other unseen market factors which significantly affect IP values are changing the way in which valuation professionals analyse comparable transactions when adopting the market approach to IP valuation.

For example, changes are pending in the regulatory and judicial IP environments in China, Korea, India and the European Union. In the United States, the increased opportunities to challenge a patent at the US Patent and Trademark Office outside of litigation and the Supreme Court rulings in *eBay* (effectively ending injunction possibilities for non-practising entities (NPEs)), *Quanta* (limiting rights to damages from downstream users) and *Alice* (limiting business method patents) have all added risk and likely reduced patent owners' ability to realise value from patents. So have recent Federal Circuit rulings on damages – most of which have restricted the scope of a patent owner's ability to claim damages or increased the evidentiary burden for doing so. Recent US Federal Trade Commission actions have also tended to limit patent owners' rights (eg, the investigation of licensing practices of NPEs and the decade-long fight to prevent so-called reverse payment settlements in the pharmaceutical industry). Whatever their merits from an antitrust or public policy perspective, these actions have introduced substantial costs and risks for patent owners. Finally, proposed patent reform legislation proceeding through the US Congress may add significant additional factors to the economics of IP deals.

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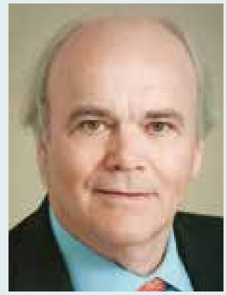
Mr Kennedy started his professional career in 1985 as a certified public accountant for Coopers & Lybrand (now PricewaterhouseCoopers). He has been recognised as an IP, licensing and damages expert and practises in the US Department of Justice, the US Court of Federal Claims, US district courts and International Chamber of Commerce arbitration proceedings.



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William Kerr is an expert in the economics of intellectual property and competitiveness. He has produced several books and articles on these subjects, including a leading treatise on the economics of IP damages (with co-author Dick Troxel), now in its 10th edition.

In more than 30 years as a professional economist, Dr Kerr has taught economics and statistics and advised government and private clients on issues ranging from tax policy to economic development, M&A matters and the development of international trade and licensing programmes. He has testified as an expert in litigation relating to intellectual property, antitrust issues, commercial disputes, international trade and employment and discrimination matters.

These regulatory, judicial and legislative actions will likely affect the market for IP assets in ways that will not be found on the surface of individual transactions that might otherwise be deemed comparable. While some changes are designed to enhance patent holder rights and weed out bad actors, the overall effect is a continued chilling of the previously hot IP market.

Traditionally, market comparables have been identified using the variables associated with an agreement between two parties at a specific point in time. However, due to the amount of new regulatory and legislative changes taking place, adjustments to the market approach could require consideration of variables effective in the near future. These factors must be quantified in order for the market approach to produce meaningful and complete adjusted current values.

Market comparables: not what they used to be

Increasingly, simply considering the identity of the parties can lead to significant adjustments in the true value of the transaction. For example, with the emergence of RPX Corporation as a defensive patent aggregator (maybe better described as a licensor on behalf of its members) or of Google as a cash-rich company offering to buy patent portfolios to keep them out of the hands of NPEs (or so it says), what would otherwise be considered a comparable transaction may be no more than a distressed asset sale.

RPX has spent approximately $800 million to acquire 2,900 patents that could have been enforced against its member clients. RPX charges clients membership or subscription fees (totalling approximately $250 million last year) to obtain 'coverage' patents owned by RPX or to be acquired in the future. Who is the real buyer or licensee: RPX, its member companies or both? To ascertain the true economics of a transaction, consider what the real or ultimate willing buyer has paid in total for coverage or a licence to a patent portfolio. For RPX members, the total amount allocated to a particular patent portfolio out of total dues

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paid on an ongoing regular and historical basis, and any additional special assessments by RPX (via additional individual company contributions towards the acquisition of a particular portfolio or licence), may be impossible to determine without in-depth discovery through litigation – assuming that the litigation involves discovery from all parties involved in a comparable transaction.

Further, consider a situation where a patent seller would consider a purchase offer from Google (which promises not to enforce a patent) only due to its fear of being connected with NPE activity. Is that transaction a market comparable? No. The true value of the seller's patent could be realised only within a framework of competitive bidding. Values established through sales that have excluded a class of potential bidders/buyers may not represent the full value for comparative purposes.

Additionally, certain law firms have decided not to offer representation to NPEs. Some corporations have said that they will not hire law firms that represent NPEs. Since IP licensors and sellers historically had a wider choice of law firms unaffected by NPE association and more leverage to negotiate for lower legal fees, these factors affect true value and indicate that comparable transactions are not what they used to be.

Global regulatory pressure on royalty rates

One does not have to look far to witness the recent impact of regulatory agencies on IP pricing and comparable transactions. In 2014 the US Federal Trade Commission issued subpoenas to companies operating as licensing entities. The cost to fully comply was significant for these companies, even though there was no allegation of wrongdoing. This type of regulatory focus could have an additional impact on prices in the licensing marketplace. Logically, licensees may even choose to reduce royalty rates demanded in an effort to avoid scrutiny.

Last year Qualcomm settled an investigation into alleged unfair licensing practices in China and paid a fine of over $900 million, in addition to agreeing to cap the royalty rates it will charge Chinese companies. Following suit, earlier this year the Korean government announced a similar probe of Qualcomm's licensing activities. IP valuation professionals must not only reconsider what a comparable rate or a comparable transaction is when regulatory agencies have influenced transactions, but also accept that different countries apply different standards, leading to a range of values. A study of previous deals and licence agreements for Qualcomm could indicate a higher royalty rate than the new rates in the press. However, the allure of new lower rates for their domestic companies and large settlement fines could lead regulatory agencies around the world to initiate similar actions. Again, more unseen portions of the iceberg – or maybe the portion below water is actually increasing for IP owners.

Judicial reforms continue to affect market approach

Valuation professionals have faced dramatic changes in case law that have led to the elimination of many comparable transactions. Specifically, historical damages awards based on the 25% rule of thumb, royalty rates that do not consider apportionment and the 'entire market value' rule are no longer instructive as comparable transactions in a litigation setting. The full effect of this new case law is as yet unrealised and will make true comparable transactions even more difficult to find, or at least harder to adjust.

Those looking for comparable transactions are also faced with pending judicial reforms that could have an impact on historical comparable transactions. Reform of the EU patent system could result in an overall upward adjustment of historical royalty rates divined from previous comparable transactions in the European Union. Patent owners will likely have the option to file patents in all EU member states and file litigation covering multiple jurisdictions. As a result, the overall expansion of the ability to enforce throughout the European Union could increase negotiating leverage for IP owners in the European Union. Germany has already become a more popular venue for IP litigation due to increased odds of an injunction – especially compared with the decreasing odds in the United States. A credible threat of injunction has always been a powerful weapon of negotiating leverage. Leverage is one of the undocumented factors (below the surface) that must be considered in the analysis of an otherwise comparable transaction.

In China, pending judicial reforms may increase the amount of damages that a plaintiff may claim in infringement cases. The current level is Rmb1 million (approximately $160,000). It remains to be seen what new limits will come out of pending reforms.

New views on royalty stacking, patent hold-up and hold-out

A growing number of IP professionals have written about the impact of royalty stacking, patent hold-up and hold-out on royalty rates. While each issue may affect royalty rates, licensing professionals conducting comparable analyses need to look more closely at the empirical evidence – or lack thereof – in actual transactions to determine the true effect of these theories on valuation.

High-tech industries, such as the mobile phone handset market, continue to be the focus of royalty stacking and hold-up debates, because "innovation is often cumulative, and products include many components protected by patents held by many different patent holders" (Damien Geradin, Anne Layne-Farrar and Jorge Padilla, "Royalty Stacking in High Tech Industries: Separating Myth from Reality", CEPR Discussion Paper DP6091, 2007). Royalty stacking occurs when a single product potentially infringes many patents and thus may require payment of royalties to multiple sources which, stacked together, represent the entire royalty burden. This arguably drives up the cost of obtaining all necessary licences to operate and, combined with hold-up injunction threats, stifles corporate growth.

Economists occupy both sides of the royalty stacking debate. Mark Lemley and Carl Shapiro point to royalty stacking problems due to the high number of essential standards and a large number of patents disclosed by owners as essential to those standards ("Patent Holdup and Royalty Stacking", *Texas Law Review* 85:1991, 1992). However, Geradin, Layne-Farrar and Padilla find "little evidence of systematic problems of royalty stacking" ("The Complements Problem within Standard Setting: Assessing The Evidence On Royalty Stacking", *Boston University Journal of Science and Technology Law* 14(2), 2008).

While companies fight to avoid paying excessive royalties, patent owners often have valid complaints that some infringers are guilty of hold-out. 'Hold-out' involves creating unreasonable delays in licensing negotiations and the litigation process, while enabling original equipment manufacturers to continue selling infringing products without paying royalties. Although difficult to prove (because infringers are unlikely to acknowledge it), hold-out's existence is believed to be real and growing. Large companies with significant cash on their balance sheets can drag out licensing negotiations and litigation for years, effectively holding out for lower royalty rates and litigation settlements. For example, Apple has both the means and motivation to hold out for long periods. With over $190 billion in cash and potential royalty liabilities of billions of dollars in product sales, Apple derives immense financial benefit from delaying the payment of licence fees or settlement of litigation. As a result, when a settlement with Apple is used as a comparable transaction, its staying power and ability to finance long-term litigation for years for more favourable terms (ie, its leverage) must be considered and likely adjusted for comparability.

IP licensors (or sellers) naturally indicate the lack of specific empirical evidence that royalty stacking has kept companies from reasonable profitability within a particular marketplace – while licensees (or buyers) have a fair share of economists to back them up. The same is true for hold-up and hold-out. Whether these factors are rightly used to make adjustments to comparable transactions, they lie below the surface of the stated terms of a deal and can have a significant impact on the true value exchanged.

Analysing unseen company-specific factors

The company-specific factors that affect IP valuations are as complex as ever and may be tied to the external factors above. For example, infringers may avoid paying royalties for a period because of the combination of other companies holding out and a patent holder's limited ability to address all infringers simultaneously. This management bandwidth problem can affect large and small companies alike. Global litigation with one or two major competitors may take up the time available for patent licensing and enforcement, making a company more likely to strike below-market rate deals with some licensees in order to avoid litigation or prolonged negotiations that it would otherwise not have time to pursue.

Comparable transaction values must also be adjusted for other company-specific factors at the time of the transaction. Depending on market conditions, other available sources of capital and whether the extent of potential royalties have been factored into a company's projections, a licensor or seller may accept less than the apparently correct value in order to adjust for comparability at a different point in time. For example, a seemingly fully negotiated royalty may be affected significantly by the current capital needs of the licensor, which may not be a factor at the time of valuation. A fully paid-up licence for $100 million may be enough to save a business at one point or fund a capital project beyond typical sources of financing, while not resembling the true market value of the licence a year or two later. The cost of capital discount and other net present value-type adjustments to the royalty stream may not capture all realities of the full discount offered for reasons below the surface of company disclosures or details of the negotiations.

Conclusion

The market approach and its use of comparable transactions can be useful in valuing IP assets, especially in normal business situations outside of litigation. However, especially in connection with evaluating damages in IP litigation, it is increasingly difficult to find IP licences to use as comparables and to adjust for inevitable differences between the comparables and the target transaction. Valuation professionals, licensees and licensors must work to distil individual deal terms down to true comparability for useful validation of valuations and to use in negotiations and litigation. *iam*

The views and opinions expressed in this article are those of the author(s) and do not necessarily reflect the opinions, position or policy of Berkeley Research Group, LLC or its other employees and affiliates

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