

Berkeley Center for Law & Technology
(BCLT)
Theory and Practice of Patent Valuation

Perspectives from Corporate Counsel
February 6, 2009 1:00pm – 2:30pm
Pete Tennent, IBM IP Counsel

Context

- | | | |
|-----------------------|--------------------------------------|-------------------------------------|
| ■ IP Transaction | <u>Valuation</u> | |
| • Before | "Pricing" | |
| • After | "Tax and Accounting" | |
| • "At" | "(Fair) Value" | |
| ■ IP Litigation | | |
| • Yes | Plaintiff vs. Defendant | damages/injunction & cost avoidance |
| • No | "Seller" & "Buyer" | market negotiation |
| ■ Other Party | | |
| • Adversary | Competitor; IP Holder; Regulator | |
| • "Partner" | Customer; Supplier; JV/JD; Affiliate | |
| ■ "Business" Transfer | | |
| • Yes | Sell/Divest/Liquidate | Buy/Invest/M&A |
| • No | IP Transfer | |

Context

- IP

Pure =
an "exclusionary" right, below

Hybrid =
> 1

- Patent
- Copyright / Mask Work
- Trade/Service Mark/Dress etc.
- Confidential/Trade Secret / Know/Show-how etc.

- IP Transfer

Outbound

Inbound

Cross

- Assignment*

Assignor

Assignee

Both

- License

Licensor

Licensee

Both

- Exclusive*
- Nonexclusive

*With or without (broad or narrow) license back.

Note: IP Transfer Agreement ts&cs critically impact valuation.

Valuation Example: Patent Cross License

- Two (2) information technology (IT) companies (A and B) desire to negotiate a (pure) patent cross license with one another.
- The companies compete with one another (i.e., are competitors) and are not "partners" (e.g., customer, supplier, etc).
- Both are domiciled in US but do business worldwide.
- Neither company has specific "proof packages" (infringement assertions) against the other "in hand".
- Key terms and conditions:
 - Nonexclusive patent license to make, use, sell, etc.
 - Five (5) year term agreement for patents having an effective filing date before five (5) years out ("futures date")
 - "Field of use" definitions
 - Transferability/sublicensing restrictions
 - Release/waiver for past acts
 - Agreement ts&cs are confidential

Valuation Example: Patent Cross License

■ Company	<u>A</u>	<u>B</u>
• Type of Business	IT general	IT specific ("widgets")
• Active Patents	45K 30K US 15K ~US	5K 1K US 4K ~US
• Annual Revenue	\$100B \$50B US \$50B ~US	\$20B \$5B US \$15B ~US
• Annual Net Income	\$10B	\$1B

Valuation Example: Patent Cross License

- Annual "value" of (potential) licensor's patent portfolio to (potential) licensee ($\$VALUE$) =
- # licensor's patents ($\#PATENTS$) X
- \$ licensee's annual revenue ($\$REVENUE$) X
- %RATE
 - where %RATE = rate of return (%ROR) X probability factor (%P)
 - %ROR = both desired & "reasonable"
 - %P = probability of having *at least* one patent that "reads on" licensee's products/processes accounting for ALL \$REVENUE (i.e., "put them out of business" = get an injunction against all products/processes = deprive them of all \$REVENUE).
- A's $\$VALUE = 45K \times \$20B \times \%RATE$ and B's $\$VALUE = 5K \times \$100B \times \%RATE$
- "Balancing" payment from **B to A** = A's $\$VALUE - B$'s $\$VALUE$
- For arbitrary %RATE, where %ROR = .000001, P = .05 for A, P = .01 for B, the annual balancing payment from **B to A** could be:
 - \$4.5M - \$.5M = \$4M
- Payment schedule in the patent cross license agreement could then be:
 - \$4M per year for 5 years (installments); or
 - ~\$12.5M one time fee, upon signing (NPV(\$20M, 5 years, 10% discount) = ~\$12.5M).

Valuation Example: Patent Cross License

- Negotiation/Valuation factors:
 - Freedom of Action; Freedom from Suit; Certainty/Predictability vs. Uncertainty/Unpredictability
 - *Quantity* of respective patent portfolios (related to the probability of having relevant patents)
 - *Quality* of respective patent portfolios (both now and later)
 - *Revenue* for each company that is relevant to the patents of the other company
 - "What the market will bear" based on the relevant revenue and the relevant patent portfolios

“Tax and Accounting”

- IBM 2007 Annual Report
 - <http://www.ibm.com/annualreport/2007/>
- "Balance sheet"
 - Business combinations/goodwill/intangible assets
- "Income statement"
 - Intellectual property and custom development income
 - Other Income

IBM Consolidated statement of financial position (abbreviated)
At December 31, 2007, \$ in APPROX. billions,

Assets

Total current assets	53
Plant, rental machines and other property - net	15
Long-term financing receivables	12
Prepaid pension assets	17
Goodwill	14
Intangible assets - net	2
Investments and sundry assets	7
Total Assets	120

Liabilities and Shareholder's Equity

Total Liabilities	92
Total Stockholder's Equity	28
Total Liabilities and Stockholder's Equity	120

IBM Consolidated statement of earnings (abbreviated)
For the year ended December 31, 2007, \$ in APPROX. billions

Revenue	
Total Revenue	99
Total Cost	57
Gross Profit	42
Expenses and Other Income	
SG&A	22
RD&E	6
IP & custom development income	(1)
Other (income) and expense	(1)
Interest expense	1
Total Expense and Other Income	27
Net Income (after provision for taxes)	10

Business combinations and intangible assets including goodwill

*The company accounts for business combinations using the purchase method of accounting and accordingly, the **assets and liabilities** of the acquired entities are recorded at their **estimated fair values at the acquisition date**. **Goodwill represents the excess of the purchase price over the fair value of net assets, including the amount assigned to identifiable intangible assets**. The company does not amortize the goodwill balance. Substantially all of the goodwill is not deductible for tax purposes. The primary drivers that generate goodwill are the value of synergies between the acquired entities and the company and the acquired assembled workforce, neither of which qualifies as an identifiable intangible asset. **Identifiable intangible assets with finite lives are amortized over their useful lives**. See note C, "Acquisitions/Divestitures," ... and note I, "Intangible Assets Including Goodwill," ... for additional information. The results of operations of acquired businesses are included in the Consolidated Financial Statements from the acquisition date.*

Intellectual Property and Custom Development Income

*As part of the company's business model and as a result of the company's ongoing investment in research and development, the company **licenses and sells the rights to certain of its intellectual property (IP)** including internally developed patents, trade secrets and technological know-how. Certain transfers of IP to third parties are **licensing/royalty-based and other transfers are transaction-based sales and other transfers**. Licensing/royalty-based fees involve transfers in which the company earns the income over time, or the amount of income is not fixed or determinable until the licensee sells future related products (i.e., **variable royalty, based upon licensee's revenue**). Sales and other transfers typically include transfers of IP whereby the company has fulfilled its obligations and the fee received is **fixed or determinable at the transfer date**. The company also enters into **cross-licensing arrangements of patents, and income from these arrangements is recorded only to the extent cash is received**. Furthermore, the company earns income from certain custom development projects for strategic technology partners and specific clients. The company records the income from these projects when the fee is realized or realizable and earned, is not refundable and is not dependent upon the success of the project.*

Other (Income) and Expense

*Other (income) and expense includes interest income (other than from Global Financing external business transactions), gains and losses on certain derivative instruments, gains and losses from securities and other investments, gains and losses from certain real estate transactions, foreign currency transaction gains and losses, **gains and losses from the sale of businesses** and amounts related to accretion of asset retirement obligations. Certain special actions ... are also included in Other (income) and expense.*