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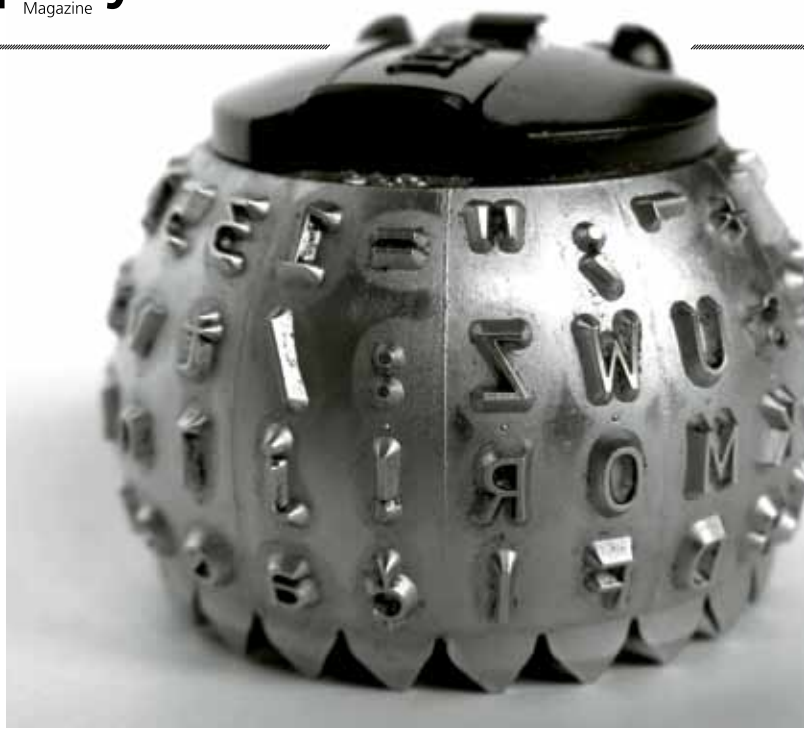
Hedging your intellectual property bets

IPOffering's **Richard Ehrlickman** explains why twinning hedge funds with IP will become a more common practice



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Remember the IBM Selectric? Introduced in 1961, it was that typewriter that used an interchangeable "golf ball" element instead of individual levers for each letter or character. And despite its name, it was mostly mechanical and relied only slightly on electricity. In fact, its electric functions could also be performed with a hand crank.

The Selectric was one of the last great mechanical patented inventions of the 20th century. For 15 years, IBM enjoyed a monopoly on typewriters with the "ball" element because of its patent. Only in the late 1970s, when IBM's patent expired, did other companies have a chance to produce similar typewriters – but none came close to IBM's success.

Senator Patrick Leahy even made reference to the Selectric during debate on the legislation that became the America Invents Act, "A patent system developed for a 1952 economy – before the internet, before cellphones, before computers, before photocopiers, even before the IBM Selectric typewriter – needs to be reconsidered in light of 21st century realities, while staying true to the consistent constitutional imperative of encouraging innovation and invention," he said.

The new patent ecosystem

Whether you were for or against his patent reform bill, Senator Leahy was right about one thing: times have changed. If you were to describe the current patent environment in one word, "complex" would be a good choice. Most of the patents issued today are not for entirely new inventions, but for improvements on previously patented inventions which, in turn, could be an improvement on yet a previous patented invention. Many companies now share the same technology, and not just among competitors but among businesses in entirely different industries (eg, smartphones, cameras, video games and computers). The result is that the same big technology corporations that are cross-licensing each other's patents and also suing each other for patent infringement.

Long gone are the days when a company could thoroughly monopolise a technology the way IBM did with its Selectric half a century ago. For both offensive and defensive purposes, patents are critical to a business's competitiveness. And there are many ways to monetise them.

Generating value from patents

With interest in patents at an all-time high, and the value of patents reaching new heights , there are several ways to monetise them – and several types of businesses involved in IP from every angle. With a patent, you can:

Practice the patented invention. Patents exist, of course, so that new technologies can be shared for the greater good of society while also rewarding the inventor for the time, talent, resources and ingenuity that went into the patented invention. Patents grant, according to Article I, Section 8 of the US Constitution, a monopoly "for limited times to authors and inventors the exclusive right to their respective writings and discoveries" in order to "promote the progress of science and useful arts". Most businesses that develop new technologies patent them and use those patents to develop new products, open up new markets, increase their competiveness, and grow their sales and profits.

License Patents. Enterprises either license or cross license, and universities often license patents, to generate additional revenue in areas they are currently not practising. This process is often referred to as "carrot licensing" as compared to "stick licensing" (or enforcement – more on that below).

Enforce the patent on one's own (costly and very resource and time intensive) or utilise a contingency patent enforcement firm. Some law firms and IP consulting firms offer patent enforcement on a contingency basis so patent owners have expert help to assert and monetise their patents without paying upfront fees. This service is especially useful for independent inventors and small businesses that otherwise would not have the capital needed to finance patent infringement litigation. Some of the best known firms providing patent enforcement on contingency include the law firm of Niro, Haller & Niro, IP Navigation Group, General Patent Corporation and Acacia Research Group.

Invent to license. Some companies employ R&D departments and patent their inventions, but instead of manufacturing the patented products, they license their patents to third parties and generate revenue purely through licensing. Thomas Edison – unlike other inventors of his time such as Alexander Graham Bell, Elisha Otis, George Westinghouse, Willis Carrier and Clarence Birdseye who built companies based on their inventions – chose to license his patents and use the revenue to fund yet more inventions at his "invention factory" in West Orange, New Jersey. Two of the larger holding companies that fall into this category are Rambus Inc, which became known for developing and aggressively litigating its synchronous dynamic random-access memory patents, and Tessera Technologies Inc, which specialises in nanotechnology and computer chip packaging, but has turned patent licensing into a major portion of its revenue stream.

Use specialty funds. Beyond the traditional use of patents to protect market share and enjoy a limited monopoly, there are some companies that aggregate patent portfolios for the sole purpose of licensing them to other companies and litigating if necessary. Examples of these patent hedge funds include Altitude Capital, Digitude Innovations, and Rembrandt IP Management. Another notable specialty fund is Round Rock Research LLC, which acquired a portfolio of 4,500 patents from Micron Technology Inc with the intent of licensing them. The largest of these non-practising patent aggregators is Intellectual

Ventures Management LLC, which was founded by a former Microsoft executive and has been estimated to own anywhere from 30,000-60,000 patents.

Some of these patent hedge funds buy and aggregate patent portfolios on behalf of clients for defensive or offensive purposes. Such a fund can also be used to help companies monetise their underperforming patents through licensing or litigation, but without running the risk of exposing the original patent owner to the risk of a lawsuit.

Trolls hiding in the hedges?

Patent holding companies that license and enforce – but do *not practice* – the patents they aggregate are controversial creatures. And they go by different names, depending on whether they are portrayed in a positive, neutral or negative light. Those who are positive to the idea of a patent holding company call it a patent licensing and enforcement company (PLEC); those who are neutral on the issue call them non-practising entities, or NPEs; and those who despise their very existence (perhaps because they've been sued by one) use the derogatory term "patent troll".

"Whatever your opinion of NPEs, it is undeniable that they are here to stay – and so is the litigious culture in the IP world. As the number of patents issued has skyrocketed over the past two decades, so has the number of patent infringement lawsuits."

Patent trolls present a threat to traditional business because they have so little to lose. They have no products, so they are not infringing anyone else's patents and thus have no need to cross-license. But patent hedge funds are not the only NPEs: universities are often NPEs, using licensing as a form of fundraising. And for individual inventors and smaller businesses, the ability to license patents is a way to compete in a system that overwhelmingly favours large corporations.

Whatever your opinion of NPEs, it is undeniable that they are here to stay – and so is the litigious culture in the IP world. As the number of patents issued has skyrocketed over the past two decades, so has the number of patent infringement lawsuits.

The rise of the "patent troll" has done something remarkable for patents and patent owners, however. It has awakened the financial markets to the importance of these previously ignored intangible assets, both for expanding business and fending off the threat of patent litigation. In fact, it is not uncommon today for a business's IP assets to be worth more than the business itself. Case in point is Nortel Networks. When the Canadian telecom giant went bankrupt, its business units sold for $3.2bn, and its patents were sold to a consortium called "Rockstar Bidco" (what does that name tell you about the status of patents today?) for a whopping $4.5bn.

In fact, companies that develop and patent new inventions with the intent of practising those inventions often end up supplying IP inventory to the patent enforcement companies. For example, Company A has several licensing agreements with Company B, but Company B is infringing a patent of Company A. Company A does not want to get into the messy business of enforcing a patent against Company B, so Company A sells its infringed patent to a patent enforcement fund, and lets the patent enforcement firm assert the patent, free from any licensing encumbrances.

Supporting players in the IP world

In the complex (and expensive) picture we've just painted of the patent landscape, there are also companies that help businesses buy, sell or license patents to create value for the inventor or owner, and in some cases obtain value from patents that have not lived up to their potential value. Patent brokers help facilitate patent sales and purchases between hedge funds, businesses, universities, inventors and any other entity interested in selling or buying IP.

Patent auctions are another option for selling patents, but can be a risky venture. As the seller is known, and if the patent(s) do not sell for the hoped-for amount (or at all), it could lower the value of your patent portfolio and jeopardise future sales.

Using a broker creates a sort of "private auction" in which either the buyer or seller (or both) can remain anonymous. This is useful, for example, when you are trying to keep competitors from discovering strategic intelligence on your company.

Are hedge funds and patent trolls here to stay?

Whether you have invested in your patent portfolio through inventing and patenting your inventions, buying and assembling a strong portfolio of similar patents in the same technology, or a combination of the two approaches, you want them to provide as much value as possible. Indeed, a strong IP portfolio is virtually a must now – as Facebook recently learned when it was sued by Yahoo. Now Facebook is buying patents to bolster its portfolio for the same defensive and offensive reasons that hedge funds are aggregating patents for their clients and investors.

The value of IP in general – and patents in particular – is only growing, and so is the awareness of the financial impact a company's patent portfolio has on that business as a whole. These days, when performing due diligence on a company for merger and acquisition purposes, determining the value of that business's IP must not be overlooked.

In this kind of environment, it is likely that patents will only become *more* important – for companies that practice their patents and NPEs alike. It is no coincidence that patent application filings are at an all-time high, or that most of the largest patent damages awards and settlements have taken place since 2002.

To come full circle, remember IBM and its Selectric success? IBM has not forgotten the power of the patent: for the past 19 years, it has been the top recipient of US patents, and was issued with 6,180 new patents in 2011 alone. So when Facebook or Google needed to buy some patents to shore up their portfolios, IBM had plenty to spare.

It used to be that IP represented only about 10% of a company's value, but there has been a paradigm shift over the past two or three decades. Welcome to the brave new world of IP – complete with its hedge funds, big-dollar patent sales and high-stakes litigation.

Author

Richard Ehrlickman is founder and president of IPOfferings LLC, a provider of intellectual property transaction and consulting services that help clients identify IP asset value, and leverage and monetise those assets to increase shareholder value. He previously served as vice president of intellectual property and licensing at IBM where he was responsible for patent and technology IP licensing, alliances, acquisitions, and divestiture of assets. Mr Ehrlickman holds a BS in electrical engineering from City College of New York and an MS in computer engineering from Syracuse University. He is a certified licensing professional (CLP) from the Licensing Executives Society.