

SELLING THE CROWN JEWELS

The global economic downturn and subsequent shortage of capital have resulted in an increase in the amount of intellectual property being sold. Wyn Jenkins explores the reasons for this, and looks at who the buyers are and what it will mean for innovation in the long term.

California-based Irvine Sensors Corporation designs, develops, manufactures and sells compact 3D electronic imaging systems, such as miniature infrared cameras. Its products have a wide range of uses and, as at September 2008, it had some 77 effective patents registered, with more pending. The firm is built around creating and extracting value from intellectual property.

But many of its products are still being developed and, as such, many of its clients are US government agencies that fund research and development (R&D) into various products and their applications. Some 40 percent of Irvine's 2008 revenue came from such agencies, while another 26 percent came from contractors ultimately working for such agencies.

Government agencies can be slow-moving, however, and contracts are often delayed. This is not uncommon in government-funded R&D, but it has not helped Irvine, which must maintain a considerable cost base in order to keep a highly skilled workforce in place for when contracts do arrive.

This has meant that the company has been unprofitable. To overcome the resulting working capital problems, Irvine has historically financed its operations through various equity instruments. It also took on long-term debt in 2006 to finance an acquisition.

There is little unusual in any of this: Irvine is a typical high-tech company that needs funding until one or more of its products becomes fully commercialised and profitable. But its latest solution to its funding problems is more remarkable. It recently closed a landmark deal that strengthened its balance sheet and solved its cash flow problems instantly.

On March 20, 2009, it completed the sale of most of its patents and patent applications to Arolase Development for \$9.5 million in cash. The deal represents an ideal solution for Irvine. Arolase licenses the patented technology back to Irvine, allowing the company to use it royalty-free worldwide. It receives a big cash injection now that enables it to continue all its previous activities.

"This is a watershed transaction for us. It immensely improves our liquidity and balance sheet, and we believe it demonstrates potential for the future," says John Carson, the chairman and chief executive of Irvine Sensors.

But more than being a good solution to Irvine's immediate problems, Carson also believes the concept could be used again, potentially changing the company's business model.

"We have been investigating means to monetise our patent assets for some time. [This deal] could influence our business model, since our research and development business has historically generated a substantial number of patentable innovations every year, which might form the basis for additional transactions of this kind in the future," he explains.

"We expect that our core research and development business will continue to be a source of patentable innovations every year, and this approach to monetising such assets is very attractive. In addition, the immediate infusion of capital positions us to pursue multiple market opportunities."

To many companies, the idea of selling their intellectual property—often their most important asset—to a third party is one that is difficult to grasp. Although many businesses might welcome the subsequent and immediate cash injection, the idea is contrary to the way most IP-orientated ventures view their IP. Most prefer to protect it at all costs.

That mentality has started to change. IP has increasingly been bought and sold as a commodity in recent years—removed from its original inventors and offered to its eventual owners, which are able to commercialise it. A much more mature market has been established in the past three to five years, but the past 12 months have seen an explosion in the number of companies looking to monetise this type of asset.

It seems that the global economic downturn has accelerated this trend, and Irvine Sensors is far from alone in what it has done and its reasons

for doing so. Many other companies—especially entrepreneurial technology companies in need of additional funding, which would have normally been provided by banks or private equity—are now exploring selling bundles of IP as an alternative option.

"There has been a significant up-tick in some sectors in terms of IP sales, although it has to be said that others are down," says Art Monk, chief executive of Inflexion Point Analytics, part of a California-based investment bank that specialises in helping companies buy, sell and monetise their intellectual property.

"There is much more IP for sale out there because some companies have run out of other financial options," he says. "Things have really ramped up since June or July last year, and it is definitely linked to the economic downturn. There are companies that would never before have considered selling their crown jewels, but that are now working on deals to do exactly that."

Others agree. Chicago-based Ocean Tomo has been at the cutting edge of buying and selling patents and other forms of IP since it was formed in 1988. It founded the first investment banking practice dedicated to this field, the first IP-dedicated private equity fund, the first public auction market for IP, and the first index to reflect the value of IP—the Ocean Tomo 300® Patent Index, which was launched in September 2008 on the American Stock Exchange.

James Malackowski, its chief executive, confirmed recently that IP sales are growing—in part as a result of the downturn. "The patent marketplace is evolving rapidly, as part of the natural maturation of the industry and as a result of the current economic climate," he says.

He adds that although IP has historically been slightly counter-cyclical, the rapid drop in the stock market at the end of last year resulted in an unusual period of inactivity between November and January. "But activity then spiked and is starting to resume normal patterns," he says.

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There is certainly much other evidence—anecdotal and otherwise—that IP, especially patents, is being sold in much greater quantities than ever before and for reasons similar to those of Irvine. And it is not just in the US.

VocalTec Communications, an Israel-based provider of multimedia and voice-over IP (VoIP) communication technology, represents another good example. It completed the sale of 11 patents in July 2008 to Karo Millennium for \$12.5 million and a further four patents in December 2008 for an additional \$6.2 million to Masinolli Fund Limited Liability Company. In total, it sold 15 of its 22 patents last year for a sum of \$18.7 million.

The deals were completed for similar reasons to Irvine—to raise much-needed capital, allowing the company to focus on commercialising its remaining products. It does, however, like Irvine, retain a geographically unlimited, non-exclusive licence to use the sold patents and other patent-related rights in connection with the development and marketing of its products.

“Both patent sales have no effect on our current and future product development. The meaningful proceeds from this transaction result in a stronger balance sheet, which we believe will assist us in realising the great potential of our VoIP solutions in the market as we continue executing on our growth strategy,” says Ido Gur, VocalTec’s chief executive, who only accepted the position in July 2008 on the basis that the company raise cash and focus its activities in this way.

In the company’s 2008 report and accounts, he reiterated the success of this strategy: “The successful monetisation sale during 2008 of part

of our patent portfolio maximised the value of these assets for our shareholders without any impact on our operations, and enables us to move into 2009 with a stronger ability to grow the business, return to profitability and realise the full potential of our VoIP solutions.”

It almost seems too good to be true. But the IP market has changed beyond recognition in recent years. There are now many more willing buyers of IP rights and a growing army of professionals looking to match the requirements of buyers and sellers. And once the financial markets succeed in effectively commoditising a product in this way and creating a market for it, that momentum will inevitably continue to grow.

Investment bank Inflexion Point’s description of itself on its website represents a good indicator of how perceptions surrounding intellectual property have changed in recent years and how many professionals, including lawyers, backers, consultants and accountants, are increasingly treating IP as an asset class with its own potential in the wider financial markets to be bought and sold in the same way as any asset.

“Our model is based on the premise that IP is no longer viewed merely as a bundle of legal rights to be enforced or licensed. IP is now viewed as a commercial asset class like real property or corporate securities. This change in perception has opened up a range of monetisation opportunities based on adaptation of the models that have been used with more traditional asset classes,” the statement reads.

But perception and having an army of advisers is one thing. The more important change in the market has been the emergence of a new cash-rich and aggressive form of buyer. This has meant healthy competition among buyers, and a vibrant and diverse base of interested parties for sellers to go to.

The traditional buyers of IP have been large corporates in the business of creating and exploiting IP in a very hands-on sense in order to execute either offensive or defensive strategies. Monk says that these players are still buying patents and they remain core to the market. But as with any operating company in an economic slowdown, many also have their own budget restraints.

“They [the corporates] very rarely buy speculatively now,” he says. “They do nothing based on what might happen in the future—it has to be based on a real live need, right now. If they are in litigation and a certain patent can help resolve that, they will buy it for defensive reasons. But they too are under pressure and are less active as a result.”

The second type of buyer is what Monk calls non-practising entities—essentially buyers that treat IP like any asset that can be bought and sold and exploited, without necessarily having the in-house expertise to develop and exploit specific products in real live markets. These are the new players in town and they have made a big difference to the liquidity available in the market.

These companies buy with a view to making money in other ways: to build a valuable portfolio to eventually sell on; to enforce licences globally and reap the rewards of royalty streams; or to actively seek litigation as a result of owning a patent that could be settled for a financial sum. The bigger players are also set up to fully commercialise patents.

Such ventures have been around for a few years now. The best known is perhaps Intellectual Ventures, a Washington-based patent investment fund formed in 2000 by two scientists. It invests large amounts of money in creating its own patentable inventions in-house, but it has also spent heavily on buying vast portfolios of patents, especially in recent years.

It is one of the most active players in the market right now, buying hundreds if not thousands of patents every year. As such, it sometimes plays an important role in bigger acquisitions. When video processor start-up Novafora acquired Transmeta Corporation for \$255.6 million, for example, it sold 140 of Transmeta’s patents—the ones it didn’t want—to Intellectual Ventures the same day, partly funding the deal in the process.

That meant a good result for all parties. “The acquisition of the Transmeta semiconductor patents augments one of the most comprehensive patent portfolios in the semiconductor field, which now includes more than 2,000 patents,” says Paul Reidy, vice president of semiconductor licensing at Intellectual Ventures. “This benefits our current and potential licensees by providing more access to innovation and greater opportunity for commercial success.”

The sheer number of deals in the market means that even these bigger players can be more selective, however. “The large players such as Intellectual Ventures have been around for a while now and they are seeing a big increase in the opportunities to acquire portfolios,” says Monk. “The volume of deals they are seeing, and even closing on, is just incredible. And that means they are becoming more interested in quality.”

Intellectual Ventures has carved out a path that is now being enthusiastically followed by many others. But these are often smaller players without the breadth of expertise of Intellectual Ventures,

SALE OF IP RIGHTS

and Monk warns that some may not fully understand what they are getting into.

“They have been followed into the market by a number of smaller players that see opportunities in this business,” he says. “I guess some of them just think they will give it a shot. Some do so because they see a higher rate of settled patent assertions, rather than companies proceeding to litigation.

“That can mean quick payouts, and I guess it encourages some smaller players to give it a shot. But they should take care. Patent litigation can be very expensive and drag on for a long time. And there is nothing to say that the dynamic of settling rather than fighting it out can change.”

The fact that it is a buyer’s market is also hitting the price being paid for patents. Monk classifies patents into three distinct groups: a bottom layer of junk, or patents of questionable value; a middle layer of moderately valued patents that might be of use, for example, for defensive reasons; and a top layer of the most valued and sought-after patents.

He says that in this market, where buyers have the luxury of being able to pick and choose and thereby force down the price, the bottom layer is not selling at all; the top layer is selling, but on a competitive basis to buyers watching their budgets carefully; and the middle layer is selling, but only at heavily discounted rates.

Monk stresses, however, that the market is not exhaustive at its current levels. He says it is possible that all the “true patents of quality within companies in financial jeopardy will eventually run out. There are only so many out there.”

He also believes that new structures will increasingly emerge in the way sales work. One example he cites could be where the seller only sells the rights to the use of a patent within a specific field. For example, a buyer might acquire the right to exploit a particular invention within the field of telecommunications only, with the right to enforce the patent and sue, but only within this specific field. The original owner would retain the rights to exploit that product in other industries.

Other players are also emerging with unique strategies—another indication of the market’s growing maturity—and not just in the US. ICEBERG Transactions, formed in early 2006, is a UK-based facilitator of IP deals globally. It is a subsidiary of ICEBERG Global, which actively invests in and builds start-up ventures, and also has a sister company, ICEBERG Intelligence, which provides enterprise systems and solutions to the innovation marketplace.

Unlike Ocean Tomo, which has pioneered the use of very transparent auction processes to sell IP, ICEBERG discreetly approaches both buyers and sellers of IP to engineer deals that suit all parties. But it does so quietly, behind closed doors. It prides itself on identifying suitable opportunities and quietly engineering transactions.

“We pride ourselves on having an unparalleled understanding of the IP market, and that allows us to pinpoint valuable patents and also understand who they would be of most value to,” explains Patrick Snow, chief executive and founder of ICEBERG. “We leverage our market intelligence to match IP buyers and sellers.

“We co-ordinate with IP owners and buyers to pinpoint assets and engineer deals that did not previously exist—deals that were not even on the table before we came along. And we then see those transactions through, fully executing them for clients. We certainly don’t wait for clients to knock on the door, although that does happen as well.”

Snow also acknowledges that there has been an upturn in deal flow since the summer of 2008, estimating that he has seen in the region of a 50 percent increase in both the number of inquiries and the number of deals ICEBERG is working on. He too believes this is because of the global recession.

“There is a direct correlation between these two factors,” he says, “along with a heightened awareness generally among technology companies of how they can monetise their IP assets, driven by the increased maturity of this market. The increased number of buyers and sellers has also given credibility to this market.”

However, Snow says that this surge in activity has more recently been tempered with an increased demand for higher-quality assets. This is a direct result of IP investors becoming more sophisticated in their approach, in addition to an increased onus on high-quality assets that can realise a definable return on investment on the short to medium-term horizon.

But Snow says his company must also “evangelise” the opportunities available. “Many companies may not realise that their IP can be monetised in this way in a relatively short time frame. There are companies that cottoned to this some time ago, but it has taken many tech companies much longer.” He adds that the main benefactors of selling IP rights at the moment are “in the ICT [information and communication technology] space, but there are others”.

He also has particular views about the way IP should be treated strategically by companies. Most view IP in any form as an asset. Snow argues,

however, that unless IP is used in a purposeful way and generates revenue, it may in fact be a liability.

“If it is used as part of an offensive or defensive strategy or generates revenue, then that is fine. But if not, one could argue that it actually represents a liability. Patents in particular can be costly to maintain, and infringement cases can be very costly. Many companies believe the more IP they have, the better. But one can argue that it depends on how you use it,” he says.

Such arguments if embraced by corporates should, in theory, lead to even more IP being sold. Like Monk, Snow also cites new structures that are emerging in the way IP is bought and sold, again reflecting the growing sophistication of the market.

Snow believes an important future trend will be what he calls IP venturing. This is where a corporate wanting to monetise its IP—rather than selling it outright—can assign or license it to a separate company with new shareholders, but also keep an interest in that venture. In this scenario, the company could potentially get both an initial cash consideration in addition to further revenue streams throughout the life cycle of the venture.

But there are also bigger questions at stake here. In a world where intellectual property is so freely bought and sold like any other asset, and is increasingly becoming removed from its original investors and eventual users, other fundamental questions are being asked about what this means for the future of invention.

Players such as Intellectual Ventures claim that this trend will drive and encourage invention in a far more direct way than ever before. It maintains that the type of structures it has put in place will encourage and reward inventors and innovators, be they individuals or start-ups.

Most in the industry seem to agree. “Like any new phenomenon, there are many views on how this will affect innovation,” says Snow. “But we believe that the IP transactions marketplace will have a positive impact. Increased liquidity can stimulate innovation, providing an increasing number of commercialisation and exit strategies for innovators, from large corporations right through to individual inventors.

“I have heard of some individuals selling a single patent at a trade show for in the region of \$1.0 million. That is pretty good going. But it comes down to liquidity.”

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