

15

Intellectual Property Deal Making (New)

15.1 INTRODUCTION

The Licensing Executives Society recently held their annual conference in San Antonio, Texas.¹ This professional organization is at the forefront of intellectual property (IP) management. Not only do members of this organization identify trends, they often create them. Some of the ideas that are beginning to emerge are reviewed in this chapter.

15.2 CROSS-LICENSE BALANCING PAYMENTS

When two large and competitive corporations collide, they very often settle their differences by cross-licensing their patent portfolios. This provides both parties with freedom of operation. After a successful cross-license, engineers at the participating companies are free to create new products without fear of infringing patents that are not owned by their company. Cross-licensing for freedom of operation continues as a basic IP strategy for

¹Insight for the trends described in part of this chapter were provided by Peter Wirth of Genzyme, Ted Galanthay of ST Microelectronics, and William Manning of Manning & Napier. Their participation in the recent Licensing Executives Society conference is greatly appreciated.

some industries but a new feature is surfacing. Some companies are requiring what is termed *balancing payments*. These payments compensate one of the parties in the cross-licensing arrangement for contributing a more valuable patent portfolio. Part of the reason for these balancing payments comes from top management. Many chief executive officers (CEOs) have seen the extraordinary income that companies such as Texas Instruments, IBM, and General Electric have derived from their patent portfolios. These competitive individuals also want to participate in this bounty and send mandates to middle management that require the maximization of IP exploitation. As such, cross-licensing activities are experiencing pressure for balancing payments. The pressure comes from an equally strong resistance to make such payments.

In the electronics industry, the makers of telecommunications equipment, computers, and consumer electronics have long conducted cross-licensing. For these companies, the new force in the industry is the pressure created for balancing payments. But cross-licensing is not for everyone. By contrast, the biotechnology industry has not yet embraced cross-licensing except in some rare instances. In the biotech world, licensing remains an exclusive arrangement conducted on a product basis. The risk and cost of research and bringing new products to market may cause this model to change in the future, but currently, IP in this industry is closely held and licensed on an exclusive basis.

15.3 LICENSES FOR LIMITED PERIODS

Traditionally, patents have been licensed for the life of the patents. In some industries, this is changing. Individual patents and entire portfolios are starting to be licensed for limited periods. The reason goes back to deriving maximum revenues from

15.4 UNRECOGNIZED AND HIDDEN INTELLECTUAL PROPERTY

IP. Companies that are pushing for limited-term licenses are making a bet on the future. They think that continuing research and development (R&D) will enhance their patent portfolio. The enhanced portfolio will then be more valuable. A cross-license running for the term of the patents does not afford these companies an opportunity to renegotiate the terms of the original cross-license. Limited-term licenses force the licensing parties to revisit their past deal and strike a new one. At the future date, the parties to the original agreement are betting that they will be in a superior position. Balance payments may be more easily demanded by the stronger party or may even facilitate the elimination of a competitor as one of the parties refuses to continue the original relationship. Presently, it is not clear how these limited-life licenses will play out, but it seems apparent that each company that is a party to these arrangements will be conducting significant R&D efforts in order to have new bargaining chips as limited-period cross-licenses come up for renewal.

15.4 UNRECOGNIZED AND HIDDEN INTELLECTUAL PROPERTY

Unrecognized property licensing may fade in the future. Emphasis on mining patent portfolios has caused many companies to discover idle IP and conduct licensing programs designed to exploit the rediscovered property.

Idle IP came about as a result of technology that was developed but not exploited. In the past, companies embarked on research that was associated with specific business strategies. Along the way, the strategies changed and the completed research was shelved and forgotten. Recently, possibly over only the last five years, companies have searched their IP holdings for just such properties. Once again, the driving force

behind this effort came from a desire to maximize income from past investment in IP. A large and growing field of consultants has encouraged the search for idle IP. They perform many of the efforts required to identify idle patents that possess commercial exploitation potential. They are rewarded with a fee for their efforts. Their employers then earn substantial income from selling or licensing the property that is mined from their portfolios. This effort is not completed but eventually must come to an end when the best of the idle properties are finally rediscovered.

15.5 MORE NONCORE INTELLECTUAL PROPERTY

Unrecognized IP is being brought into the sunshine and exploited through licensing. While exploitation of unrecognized IP is expected to eventually be exhausted, another type of idle property is expected to create new licensing opportunities. Mergers and acquisitions play a significant role in commerce. Business combinations come about for a variety of reasons. Sometimes, a strong company acquires a weak rival and automatically captures incremental market share. Other times, company combinations bring complementary strengths together that could not otherwise be created. Often, merger and acquisition combinations change the character of IP. A business combination often involves a new and focused strategy for the new company. Sometimes, this new strategy lessens the importance of certain IP to the combined companies. Such IP then becomes, in a sense, idle, but not unrecognized. Licensing programs are then instituted to derive income from this property. As mergers and acquisitions continue, this licensing opportunity will continue.

A variation involving noncore technology involves charitable gifts to universities. Some companies are discovering that they possess patented technology for which they no longer have strategic use. In the fall 1999 issue of *Licensing Economics Review*, a story about Procter & Gamble illustrated the benefits of this growing IP trend.

The link between corporations and universities goes beyond cash contributions and research grants. Corporations also give patented technology to universities. In return the corporation gets a tax write-off equal to the value of the donated technology. The university obtains a technology that may eventually become a generator of royalties from licensing. Society gains access to a new technology that might have otherwise been closely held by the corporation or not commercially developed at all. Recently Procter & Gamble announced that it is donating more than 40 U.S. and international patents along with other accompanying intellectual property to the Milwaukee School of Engineering (MSOE), a world leader in rapid prototyping systems. MSOE will realize all future licensing revenue from the patents.

The patents make up P&G's proprietary "PHAST" (Prototype Hard And Soft Tooling) technology, which radically reduces the time it takes to design and develop molded parts across a wide variety of fields. PHAST helps products go to market sooner. The reason for choosing MSOE was explained by Gordon Brunner, P&G chief technology officer, "MSOE was selected because it is uniquely qualified to realize the PHAST technology's full potential." According to MSOE President Hermann Viets, "PHAST technology will revolutionize the tool and die industry. PHAST is a great example of the technical and scientific innovation for which

P&G is known. With further development, this technology can be applied to everything from cooking utensils to children's toys to high-tech tennis shoe soles.”

P&G reportedly engaged an independent expert to find a worthy recipient of the PHAST technology. This donation to MSOE marks the beginning of a broad initiative by P&G to donate technologies to universities and research. P&G invests more than \$1.7 billion in research and development each year. Sometimes the intellectual property that comes from this research effort does not fit with P&G's strategy. Brunner said, “Donating these commercially viable patents and the accompanying intellectual capital to leading universities and research institutions will help us make important new connections. It will also extend the value of the technology more broadly to the world, so that more consumers can benefit much sooner.”

Rapid prototyping is a process that enables a three-dimensional product model to be created quickly and automatically from computer data. PHAST is a series of steps that accelerates standard rapid prototyping processes and produces mold inserts for prototypes more quickly, helping products get to market faster. PHAST can make prototypes up to five times faster than other conventional mold making techniques. For example, prototype injection-mold tooling can be produced by PHAST in just one-and-a-half to three weeks, compared to an industry average of six to eight weeks when using conventional methods. PHAST is particularly helpful because product developers can get initial samples off a mold much faster than before. It provides developers quick and inexpensive working samples that can be tested with consumers, then revised as needed and tested again quickly. In addition to being quick, PHAST technology is simple to use and doesn't require computer systems or designs like other rapid

15.6 MONETARIZATION OF INTELLECTUAL PROPERTY

prototyping processes. Therefore, PHAST can be taught to workers with basic tool-and-die skills, and it can be used in low-tech companies or developing countries that produce patterns by hand rather than computer.

MSOE's Rapid Prototyping Center, which is part of the university's Applied Technology Center, develops groundbreaking new products for a client consortium which includes Ford Motor Co., Harley-Davidson, Kohler Co., SC Johnson, and Gardner-Denver. The 25 companies in the consortium seek simple, timesaving approaches to producing new products. Established in 1903, Milwaukee School of Engineering is a private university educating students in both technical and nontechnical areas in the disciplines of engineering, technology, management, nursing, and communications.

P&G markets more than 300 brands to nearly five billion consumers in more than 140 countries. These brands include Crest®, Tide®, Pantene®, Pampers®, Oil of Olay®, Vicks®, and Pringles®. P&G has operations in 70 countries and employs more than 110,000 people. In fiscal year 1998–99, P&G sales were \$38 billion. P&G's has 1,500 M.D. and Ph.D. scientists leading research and development at 19 P&G technical centers around the world. In addition, P&G works closely with hundreds of universities and research and technology partners worldwide.

15.6 MONETARIZATION OF INTELLECTUAL PROPERTY

The conversion of property into liquid funds is referred to as *monetization*. Such conversions have long been associated with IP. In the past, this has been accomplished by some of the following actions:

- Licensing IP for royalty income
- Selling IP for one-time, lump-sum payments
- Initial public offerings (IPOs) of immature companies that primarily possess new technologies
- Leveraged buyouts driven by the desire to extract IP from the purchased company

A new strategy has recently emerged. Intellectual property royalty income is serving as the foundation for investment securities. An April 1998 story in *Licensing Economics Review* illustrates this trend as it is being conducted for copyrights:

Another pop icon turned to high finance as British singer Dusty Springfield announced a deal in which she would get millions of dollars in exchange for future royalties from her hits such as “You Don’t Have to Say You Love Me.” The deal was the latest in the new field of rock-and-roll financing that started with the landmark \$55 million bond offering last year set by performer David Bowie. Springfield’s deal was put together by a group formed by Prudential Investments and RZO, a specialized investment securities firm. The parties would not disclose terms, but industry sources said the financing deal was valued at under \$10 million . . .

. . . the deal was backed by the future cash flow of more than 250 record masters, or virtually every song recorded by Springfield. Her career spans four decades and includes such hits as “I Only Want to Be With You,” “Wishin’ and Hopin’” and “You Don’t Have to Say You Love Me.” Springfield was one of Britain’s top pop stars in the 1960s, known for her soulful voice, beehive hairdo and thick mascara. In the 1980s she found renewed chart success when she teamed up with the Pet Shop Boys.

Less than a year later, another story appeared in the February 1999 issue of *Licensing Economics Review* showing that IP securitization is continuing despite some skepticism:

Heavy metal band Iron Maiden became the latest musical act to hit Wall Street with the closing of a \$30 million bond offering backed by future royalties of hits like “Bring Your Daughter to the Slaughter.” The latest rock-and-roll bond deal comes as skepticism abounds about the so-called new frontier of entertainment financing, following two years of intensive hype from Hollywood and Wall Street firms. Under such “securitization” deals, the bonds are backed by the artists’ future royalties. Michael Elkin, attorney at the law firm of Thelen Reid & Priest, which structured the Iron Maiden deal stated that he was working on similar transactions worth more than \$200 million.

Music securitization has many doubters as fewer deals than expected have followed since the first bond offering backed by royalties of British rock icon David Bowie was rolled out in 1997. Many of the biggest deals said to be nearing completion, including one involving Michael Jackson, have yet to materialize. Some industry experts said the complexity and labor intensive requirements of crafting such deals have been deal-stoppers . . .

The Iron Maiden deal was similar to the one crafted by New York investment banker David Pullman for Bowie, who took out a 10-year, \$55 million loan collateralized by his future earnings from songs. Like the Bowie bond, the Iron Maiden bond would be sold in a private placement to an institutional investor in the next few weeks. The main difference between the Iron Maiden deal and Bowie’s is that the latest one involves a group of people who own

copyrights, rather than one individual. So far, the Bowie deal remains the largest music-rights securitization ever done.

There has also been an IP securitization in which patents and trade secrets were transferred to a holding company as part of an arrangement that mimicked a real estate sale-leaseback. The transferred IP served as the basis for a loan to the holding company. The funds were provided to the manufacturing company that originated the intellectual property. In return, the manufacturing company paid royalties to the holding which, in turn, used the royalty income to repay the bank loan that was collateralized by the IP.

Intellectual property is dominating all aspects of commerce and it will surely infiltrate the investment community in many different ways.

15.7 SPECIFICALLY CREATED FOR EXPLOITATION

Thomas A. Edison is often credited with creating the career of R&D. Before Edison established his Menlo Park, New Jersey, laboratories, new technology was invented haphazardly. Companies would stumble upon new technology as they conducted their businesses. This changed forever as Edison established himself in business for the specific purpose of invention. In the biotechnology industry, this business model has been continued since inception of the industry. Young biotech firms established themselves based on a new science with the goal of creating new medical therapies. Commercial exploitation for these companies has been mostly conducted through alliances with established pharmaceutical companies. Their established partners possessed broad distribution networks and efficient manufactur-

ing capabilities, and had the expertise needed for gaining regulatory approvals for new drugs. Currently, we are seeing the biotech business model being adopted in other industries. Core technologies in computer hardware and software are being developed by what have become known as IP houses. These firms have been created for the sole purpose of developing new technologies that will be exploited through licensing. The April 1999 issue of *Licensing Economics Review* provided a report that illustrates the business model being pursued by IP houses. The story is presented below:

The intellectual-property cores [*fundamental intellectual property*] industry is still the talk of Silicon Valley. Last year the idea centered on a myriad of startups that would spin semiconductor cores and larger companies would knit them together into systems on chips. However, the IP cores business is turning out to be harder than anyone thought. Problems are emerging about how to sell the cores, how much support is required and even which technologies can make a viable IP cores business. Optimally the IP core industry would allow companies to go surfing on the Web and grab different cores from a variety of places. While most industry observers agree that an IP cores industry will eventually exist, it's becoming apparent that the model won't be as easy to build as was originally thought.

The IP core business model says you remove the major costs of semiconductor development, primarily manufacturing, and concentrate on designing circuitry. It also says you're able to sell that circuitry to multiple industry players using multiple fabrication plants and to collect ongoing revenues, usually in the form of royalties.

Expectations have been high but despite a few early successes with companies such as MIPS and Rambus Inc.,

problems have surfaced. Some designs just didn't work inside a customer's chip. Prices for commodity cores plummeted and the wreckage has left many venture capitalists gun-shy about IP companies. Part of the problem is also that IP hasn't become the kind of gold strike that attracts technology investors. Compared with an e-commerce company, or even a fabless semiconductor house, the revenue growth of an IP play isn't fast enough for venture capitalists' needs. Some investors are more comfortable with investing in semiconductor IP where it is part of a company that has its own fabrication facilities.

Two elements seem to be essential to the success of the star IP core providers: a link to a massive market and the fact that the companies sell processors. Processor vendors are particularly well placed due to the emerging embedded market and "anything but Microsoft" philosophy that's cropping up in pockets of the embedded market. Embedded designs are being developed without allegiance to a particular microprocessor and standardized on a real-time operating system from a small company, which opens the door for a variety of processors to be used in a variety of designs.

So, what is it exactly that IP companies have been missing from their success formula? One quick business lesson is that IP works best when it's specialized. Commodity products attract too much competition. PCI and USB cores are prime examples, as their prices have plummeted. But at the same time, that specialized IP has to be a sustainable business, which means finding a high-volume application to match. IP companies also must take an approach that goes beyond providing compo-

nents. It's becoming clear that IP operations, like the rest of the electronics industry, must follow a systems-minded approach.

Legal concerns also must figure prominently into the business plan, because an IP company lives or dies by its patents. Although not yet a pressing problem it's possible, indeed likely, that legal questions will be the next hurdle for the IP cores industry.

IP houses are driven by the quest to develop new and fundamentally important technologies. They hope that these technologies will create new industry standards that all industry participants will need to adopt. Licensing income is then expected to be derived from all industry players that desire to stay in the industry. As the *Licensing Economic Review* article illustrates, some of these companies are publishing their core IP on the Internet, making it available for inspection and modification by potential users. This business model has yet to be fine-tuned but it is a tribute to Thomas Edison and to the strength of worldwide patent protection.

15.8 SUMMARY

The seven trends identified in this chapter include:

1. The increased demand for balancing payment when companies engage in patent portfolio cross-licensing
2. An increase in licenses that expire before the life of the patent
3. An expectation that licensing in the future will include less previously abandoned technology

4. An increase in IP transactions involving technology that is not a core component of a company's strategy
5. An increase in charitable donations of IP to universities
6. The introduction of investment securities that are based on IP values and royalty income
7. More IP being developed for the specific purposes of licensing