Embracing the new IP reality

Two innovative defensive IP models, pioneered by AST and RPX, are attracting growing numbers of operating companies as they intensify their efforts to fend off litigation from non-practising entities

By **David Hetzel**

In some ways, it clearly is the best of times for the IP world. We are seeing unprecedented attention placed on IP issues from all angles, along with widespread, robust innovation in our space. The Supreme Court of the United States is hearing IP-issue related cases at a heretofore – unseen clip and has rendered significant rulings; one of the most important, *In re Bilski*, will be handed down later this year – potentially with profound implications for every business method patent, past and future. Both houses of the US Congress are contemplating major changes to the Patent Act (the law governing patent matters for the past 50-plus years). More and more investors are viewing patents as having come of age in terms of maturing into a viable alternative asset class. Financial indices – such as the OT300 – have arisen to track the most IP-rich companies. In short, it is the best of times for professionals in this wildly dynamic IP monetisation space; we are witnessing truly unprecedented tectonic shifts within the industry.

However, not all of these changes are necessarily favourable for all participants. In fact, many corporations would argue it is the worst of times – at least from the vantage point of the emergence of a new business model: the non-practising entities (NPEs) or patent licensing enforcement companies (PLECs), more derisively referred to as patent trolls, patent pirates or even patent terrorists. Whatever term you ascribe to them, the business model they use is proving to be an increasing distraction for some corporate management teams. With their nuisance lawsuits and/or more serious threats of securing injunctions (which ultimately lead to barring a company from shipping product), NPEs are plaguing high-tech companies – effectively placing an IP tax on corporations that sell legitimate innovative products to eager consumers.

These NPEs are simply IP holding companies. Like IP ghosts striking under cover of night, they assert patents without any fear whatsoever of being bludgeoned back into submission by a counter-attacking corporation, wielding a formidable patent portfolio. So, despite the billions of research/development dollars that a company may have invested in building its patent portfolio, this is completely and utterly useless against these NPEs. In short, the model they employ is a disrupter, the likes of which has never been seen before.

Moreover, the financial backdrop to the NPE's emergence on the world IP stage is that of the worst financial crisis in over 70 years – massive layoffs and declining corporate revenues, profits and tighter margins. Taken together, one could argue this truly is the worst of times.

Historically, corporations have been relegated to fighting a rearguard battle against these NPE forces. Today, however, some very intriguing, thoughtful and wise models have emerged to empower invention-driven companies to fend off these NPEs more effectively. The purpose of this article is to approach these models from the members' perspective – comparing and contrasting key points of

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differentiation, exploring objectively their respective merits. The intent is to take a hard, non-biased, fact-based look at two front-running business models, both of which have gained significant traction in helping numerous product-producing corporations to mitigate their defensive IP litigation risks and costs.

It should be noted that not only is Motorola a proud member of Allied Security Trust (AST), but it played a leading role in founding this innovative IP defensive organisation. Motorola is also actively contemplating membership in Rational Patent Exchange (RPX), which it views as complementary to its membership in AST.

Throughout this writer's fortunate travels over the past year – from Japan to London to Copenhagen, and Stateside from San Francisco to Chicago to New York – the misunderstanding, scepticism and genuine lack of appreciation that I have encountered for the models' potential impact has been surprising, and somewhat disheartening; – this formed the inspiration for the present article. My sincere hope is to leave the reader better informed about both AST and RPX, how they operate, their plus and minus points; and, possibly, to impart a genuine enthusiasm for readers not deeply familiar with either model to engage them, if nothing more than to understand them better and contemplate the unique potential they both offer to any corporation confronted by NPEs. Either or both can play a critical role in a Fortune 1000 company's multi-pronged defensive IP strategy.

Going nowhere

The NPE business model is apparently one that is here to stay, notwithstanding the slew of recent US legal rulings that collectively have weakened patent holders' rights. Highly skilled IP professionals, backed by wealthy investors, have gravitated towards this lucrative model, which is clearly benefiting from the growing liquidity in the transactional patent marketplace –some 1,000 portfolio transactions a year for total amounts estimated to approach/exceed US$1 billion.

With surprising speed and alacrity, NPEs have climbed the previously insurmountable cliffs of identifying, acquiring and aggregating IP – both junk patents with which to conduct nuisance suits, as well as more venerable patents of true litigation quality, for which sizeable sums can be extracted. A look at their growing numbers is truly sobering. Those operating companies that plan simply to continue lumbering across the landscape with reckless disregard for the building NPE threat do so at their peril.

NPE forces have grown, gravitating towards and entrenching themselves around the brightest corporate fires (eg, Apple/iPhone/iPod and RIM/BlackBerry). Numbering nearly 300 by some counts, they have grown as financial opportunists, seeing them as a safe alternative asset investments free from the vagaries of the established capital markets, have stuffed their coffers full. Simply put, it is not uncommon for these investors to expect an ROI of 10x.

Unlevel battle field

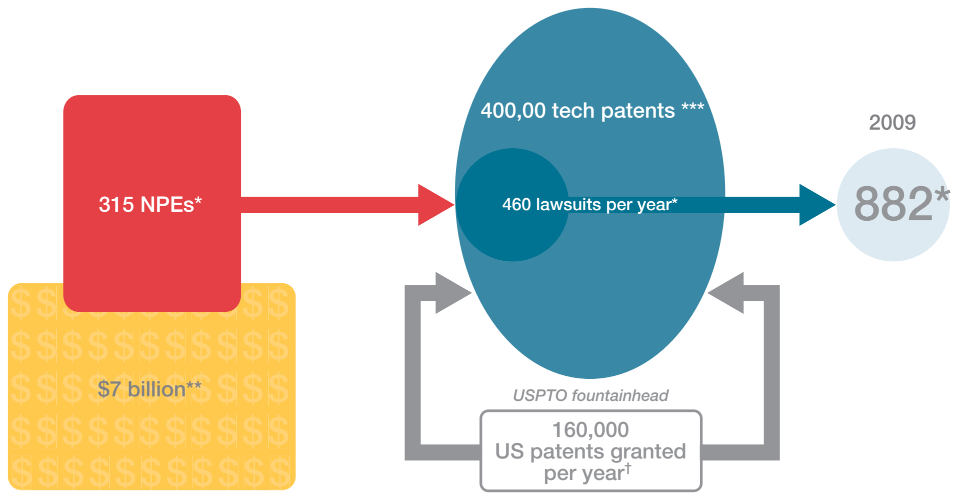
These days, operating companies have to meet SEC disclosure requirements, revealing precise dollar amounts for their revenues and profits and the geographic origins of these dollars, and sometimes even breaking out revenues by business units and/or products. All this information is vital to an NPE's efforts to formulate its strategies and custom a patent portfolio to focus on the financial jugular of a given company. They have little to no reporting obligations.

NPEs are clearly exploiting their information advantage. Moreover, defending against them has been further complicated by their seemingly unlimited ability to morph. They are no longer simply small-time IP attorneys operating on a contingency model; now in the fray we see some well-financed, large contingency law firms along with litigation investment funds with hundreds of millions of dollars at their disposal. Some 20 of the 300 or so known NPEs appear to account for roughly half of all NPE-related litigations, according to intelligence from Patent Freedom (www.patentfreedom.com).

Swimming in a sea of patents

In 2008 alone, some 900 operating companies were sued by NPEs. Taking advantage of the growing patent transaction market, NPEs have found a ready means by which to refortify themselves for their repeated attacks on corporate profitability. Some estimates put the amount of capital flowing into NPE models over the past eight years to be between US$6 billion and US$8 billion. And clearly one aggregator, Intellectual Ventures, has raised massive amounts (reportedly US$5 billion). Others, such as Altitude Capital, Acacia, Techquity and Fortress Investments, are said to have tens of millions of dollars at the ready for patent buys.

Figures 1. **The patent assertion industry targeting 882 firms in 2009**



* Patent Freedom, 2009 data
** Estimated capital flowing into NPE models from 2000-2008 (Source: RPX Corp)
*** Not including 300,000 owned by large corporations (Oliver Wyman IP seconday markets study 2009)
† US granted utility patents, not including reissues (Source: USPTO)

Is this market sustainable? Well, consider the 157,000 or so granted US patents being issued every year. On that basis, NPEs will have bountiful waters in which to feed and replenish themselves. Declining acceptance rates and the increase in USPTO examiners are easily offset against the surging deluge of applications, which now approaches some 400,000 per year, up from just 200,000 15 years ago.

In short, the patent fountain shows no signs of being turned off: more patents will make their way to the secondary transactional patent market and some are sure to find their way to NPEs, which will then assert them against operating companies.

The numbers paint a bleak picture for creative, innovative operating companies – particularly for those intensely focused on out-inventing the competition and building bigger, better, more profitable businesses. NPEs should not be regarded as a fleeting, transient phenomenon; rather, they should be recognised for the tectonic shift that they represent – one which has profound ramifications for our knowledge economy and its law. Operating companies which have not yet been educated by an aggressive NPE are blissfully proceeding forward, ignorant of the IP reality that is upon us them.

In short, a growing number of increasingly litigious NPEs have appeared over recent years. Most have formidable acquisition funds, are increasingly active and seem to be shifting to a *modus operandi* of targeting more corporations on each litigation sortie. This target dispersion of late, where NPE plaintiffs sue as many as 40 companies, is a particularly troublesome trend.

Sentinels on the corporate cliffs of despair

An enlightened few in the corporate herd have recognised the growing NPE threat for what it is and what it could mean: namely, the disgorgement of significant profits, if not complete cessation of shipping product. These corporations, through their formation of and commitment to AST and RPX, have sought to compete with the NPEs in the open patent marketplace in an attempt to prevent them from acquiring the very patents that would form the foundation for an assertion; at a minimum, their efforts will drive NPE acquisition costs higher.

While AST and RPX are different in many ways, both share the goal of mitigating the NPE threat for Fortune 1000 companies by offering cost-effective means of securing freedom of action (to operate and ship product). As such, they warrant further study. There are few alternatives to them, save draconian legal or legislative changes (which seem highly unlikely, given the counterweight of Big Pharma's need for strong patent rights). Moreover, together the two organisations have already spent nearly US$250 million on patents (and patent rights) in the short span of two years, and have attracted more than 50 corporate members.

It is important to note that whether one model is better or worse than the other is really not the issue here; clearly, each entity is certain to have its own strengths and weaknesses. Rather, through scrutinising their respective strengths and weaknesses, a deeper understanding of each respective model is sure to emerge. This comprehensive, more nuanced understanding of both models is where the value lies.

Sentinels defined

To understand these models, it is helpful first to take a high-level look at each one:

- AST is a defensive-oriented, member-owned cooperative of high-tech operating companies that seek to provide a cost-efficient means of securing freedom of action (FOA) for its members. It operates on the basis of catch and release, never holding any IP for more than a year and always allowing members to opt in/out of AST bidding on portfolios (thereby ensuring that the member cash outlay is applied only to those portfolios truly of interest to that member). Members include, but are not limited to, Motorola, RIM, Ericsson, Philips, Intel, Verizon and Avaya.
- RPX is a for-profit defensive patent aggregator that has a centralised decision-making structure allowing it to make buy/no-buy decisions quickly, on behalf of its members and with a unique degree of deal flexibility. It generally, at least for now, aims to hold/aggregate the patents it acquires. Remarkably, every member receives a licence (term converting to perpetual) for everything PRX acquires, generally speaking. Members include, but are not limited to, IBM, Cisco, Hewlett-Packard, LG, Panasonic, Coby Electronics and HTC.

Both models have gained significant traction, as demonstrated by their growing membership numbers and the hundreds of patents they have purchased. RPX has clearly outspent AST. At first sight, this may suggest that RPX has assisted its members more than AST. However, that presumes that the RPX purchases were this technically relevant to the businesses of all its members; the purchased IP would have posed a threat to the members if it had fallen into the hands of an NPE; and it was acquired for a fair price (remember, unlike AST, the RPX model does not focus on seeking to recoup its initial outlay).

So while RPX may have already significantly outspent AST, it remains unclear whether its members have benefited significantly more than AST members. Nevertheless, the spend matter aside, both models have their virtues. These can best be grasped by contemplating their comparative differences side by side (see Table 1).

Profound differences and unique characteristics

Perhaps one of the most profound differences between these two is in the decision-making process. While vetting of patents and decision-making reside with the individual members at AST, so that the AST staff plays more of a coordinating role, over at RPX members place their trust in the RPX management team to buy IP that is relevant to their current and future needs. If you are a company that does not wish to invest in building out your IP team to due diligence the 1,000-plus portfolios coming on the market every year, or simply one that does not have the bandwidth among your existing team to review these, RPX is made for you. However, only the corporate itself, and its stable of engineers, can best evaluate patents for their relevance to current and future product roadmaps, some of which may even be dark projects, unknown to anyone outside the company.

Additionally, if you are the type of buyer that likes to see what conclusion other members come to on any given portfolio of interest, and value their independent evaluation, then maybe AST would be more to your liking. The compelling idea is that if several members independently vet the IP and arrive at the conclusion that it is of such merit that they will contribute to the AST bid, then this somehow validates the patents. After all, something must be said for the collective brain trust that each AST member can access within its respective organisation, as well as the broader technical community they represent in the aggregate. In theory, this expansive network should make AST the smartest buyer on the IP block. Of course, this strength can be weakened if members fail to participate and/or lack the infrastructure consistently to mine the intellectual wherewithal that resides within their respective corporate organisations.

Turning to another key difference: catch and release v buy and hold. AST follows the former, while for the moment at least RPX prefers the later. On a theoretical level, it seems that RPX will be challenged to defend the position that tucking patent portfolios away in its IP library makes good fiscal

Table 1. **AST and RPX compared**

	Allied Security Trust (AST)	Rational Patent Exchange (RPX)
How it works		
Launched	2007	2008
Structure	Member-owned trust (DE)	For-profit VC-backed corp
Capitalisation	Purely member fees	Venture capital and member fees
Mission	To be a cost-effective means of providing members with freedom of action to operate	To lower risks/costs resulting from NPE patent assertions/litigations by removing dangerous patents from circulation and spreading the cost of such removal across a multitude of companies
Function/ *modus operandi*	Catch and release: seeks to recoup initial outlay (expense incurred in purchasing portfolio) by releasing (ie, selling) patents into the secondary patent market; this is done subsequent to encumbering patents with licences to all member companies that participated/ contributed to the winning AST bid	Catch and hold: building an IP library to which all members get equal term licence that ultimately perfects into perpetual licences after rolling two-year period
Function/decision making	Dispersed/decentralised: hub-and-spoke model wherein buy/no-buy decision-making power lies with members, and AST (hub) plays coordinating/administrative role; *ad hoc* informal sidebars between members may factor into decision making	Centralised: RPX staff make buy decisions (consults members, informally)
Number of senior IP deal professionals	1	10
Sweet spot	Forward-looking portfolios (ie, infringement footprint not yet clearly emerged, but for which member companies, with view of technical horizon, can see value in licensing far ahead of others)	Portfolios already in hands of NPE aggressor
Unique attribute	Potential to tap into technical intellectual wherewithal unrivalled by any buyer in the market; collectively, members can access /consult literally hundreds of senior engineers, thereby making AST, at least in theory, potentially the smartest buyer in the market	Collectively the team of 10 senior IP deal makers has some 100+ years of IP deal experience, and has transacted US$2 billion in patents; additionally, team has deep understanding of NPE model and broad network of NPEs
Is it working?		
US$ spend to date (since inception)	US$35 million	US$200 million
Number of patents and applications purchased	> 350	> 400
Number of patents sub-licensed (where organisation did not take title to patents)	0	200*
Members:		
• current	17	35
• optimal	30-40	100-plus
Illustrative members (non-exhaustive listing)	Motorola, RIM, Ericsson, Verizon, Philips, Avaya	IBM, Cisco, LG, Panasonic, Hewlett-Packard, HTC, Coby Electronics, InFocus Corp
What you get		
IP rights/FOA /licence	Licence to only those portfolios which you as a member contribute funds to AST bid	Licence to everything RPX acquires, although not immediately (term licence matures into perpetual only after two years)*
Weekly market intelligence report (ie, patents being shopped)	Yes	No
Third-party reports	Yes**	No
Ability to borrow and utilise patents for defensive counter-assertion measures IP aggressors against	No	Yes
What you pay		
Annual membership fee	Flat fee: US$200,000	US$35,000 to US$5 million dependent upon rate card (the higher a company's revenues, the more it is required to pay)
Amount to put in escrow	US$2 million***	$0

*Rather than taking title to patents, RPX increasingly secures sub-licensing rights to particular patent portfolios, for a pre-defined period of time. **Subject matter expert reports; generally available upon request from AST, which has built out a network of experts it asks to review and comment on particularly interesting portfolios of which AST has become aware.***This amount may be drawn down by the member company to fulfil bidding contribution obligations the member made as part of its participation in a bidding effort/series at which AST was successful.

sense. After all, the patents and their residual value simply sit there, never being fully monetised. Of course, if RPX does scale up to 200 or 300 members, then it is probably not an issue as the patent(s) would probably have a greater chance of appealing to a significant number of members.

With AST, members opt into only those portfolios which they determine are truly relevant to them. The extent of this relevance is expressed via the strength/magnitude of their financial contribution to the overall AST bid. Members generally intend to recoup their initial outlay – or at least can rest assured the AST will attempt to do so. There are no guarantees that the trust will achieve a re-sale; and, obviously, the patents are encumbered by licences to AST members (at least those that participated in the bid), which, as with any encumbrance, lowers the market value. However, there is some speculation that by virtue of AST members taking a licence, the market may perceive some sort of technical validation and that this will actually drive a higher re-sale price that exceeds AST's original winning bid.

RPX has amassed formidable bench strength, with some 10-plus senior IP deal makers. This team obviously brings vast experience and deal-making savvy to the table. In a testament to RPX's ability and inclination to do creative deals, it has secured its members – or, at least some members – licences to key IP without RPX having to take title to the patents. Not only does this lower RPX's overhead (ie, lower maintenance fees), but it also goes a long way to dispelling the myth that RPX could implode into some sort of NPE, whereby the VCs recoup the salvage value for their initial outlay.

Ability to scale is yet another point of differentiation. RPX's model may demand that it attract many more members. Of course, if it attains 200 or so, each paying US$1 million-plus, it should be on solid financial footing. This would represent a six or seven times expansion in the current membership roster, so RPX may have a way to go. However, never underestimate the capabilities (and Rolodexes) of the veteran IP team that CEO John Amster has recruited; these highly motivated individuals, with vast contact networks, may well be able to deliver.

AST, as a member-owned collective, is on a different track, and probably can be performing optimally with only 30 to 40 members. Again, there are no VC interests to appease, so amassing dues-paying members is not critical to the AST business model. In fact, should AST be wildly successful and attract 100 members, it would probably not function well on an operational level. And, thus, it would simply clone itself and spawn technology/industry-specific groups with member numbers that are more manageable.

The new IP reality

We have seen the new IP reality – and it is one in which NPEs are here to stay. Still, many companies seem to be wandering aimlessly through the valley of darkness, head down, trudging along, fixated on growing profitability, with little thought as to how to protect their hard-earned profits. Their lack of attention to building thoughtful, proactive defensive IP strategies – such as by incorporating the tactical tools of an AST or RPX – is mystifying. It places them in an increasingly precarious position. At some stage, they are likely to find themselves at a profound competitive disadvantage which to their more IP-enlightened and forward-looking competitors, have endeavoured to safeguard profit margins.

Gone are the days when high-tech CEOs could ignore IP issues. Doing so in today's knowledge-driven economy, where patents are the codification of knowledge, is to jeopardise the corporate holy grail of generating continually growing profits. Those who fail to understand this and do not embrace the change are sure to see their flames of profitability flicker, dim and perhaps ultimately be snuffed out altogether. iam

David Hetzel manages the patent divestitures & acquisitions programme for Motorola's handset enterprise and serves as Motorola's representative on the AST Operations Board

This article is dedicated to John Hall, VP, Intellectual Ventures, who passed away in November, 2009. In addition to being a fellow Midwesterner and friend, John was a class act in all ways: a pioneer; strategic thinker; consummate deal maker; a senior IP statesman; and, to me, a genuine inspiration