



The value of efficiency and transparency in IP licensing: let the market decide

Ian David McClure of IPXI explores certain movements within the US IP marketplace that open doors to successful licensing opportunities

The market for technology licensing has always been clandestine. There has never been a consistent source for price discovery. No common platform has ever existed for IP owners to find potential licensees, and vice versa. And no systematic or standardised process for facilitating transactions involving the transfer of technology has ever been successfully established. Yet, 80% of the S&P 500 corporate value is attributable to intangible assets including the intellectual property rights that are fundamental to technology use and ownership. So, why has no universal marketplace formed for the transfer of assets that are responsible for 80% of a company's value?

The need for an efficient and transparent marketplace for the exchange of IP rights has been addressed in academia for years. In 2007, Stanford IP professor and scholar, Mark Lemley, teamed with a former chief technology officer at Microsoft, Nathan Myhrvold, to publish a working paper titled *How to Make a Patent Market*.¹ Governments have entered the discussion as well. This year the European Commission completed a solicitation for service contracts to study and report on the practicability and benefits of a market for IP rights.²

Most business and legal professionals can also agree that a more robust market for intellectual property is good for business in the aggregate; and they are now taking this initiative seriously. In March of 2010, corporate executives from various industry-leading companies gathered in Dallas to offer input and set guidelines for an intellectual property marketplace rulebook. The marketplace architect, Intellectual Property Exchange International (IPXI), spearheaded the gathering in order to set approved standards for the Unit License Right (ULR) contract – a commoditised patent license that is revolutionising the transfer of technology. The rulebook sets out to govern the exchange of technology in a non-discriminatory manner via standard form licenses on publicly disclosed terms. The contemplated model resembles

the open market elements of a stock market or commodities exchange. In this light, ULR contracts address the current inefficiency of technology transfer including the time, expense, redundancy and uncertain outcome of traditional bilateral license negotiations. Each ULR contract purchased gives the buyer a right to use a pre-established unit of IP; for example, the right to make and sell up to an established quantity of products covered by the patents in question.

Other characteristics of the ULR contract marketplace simulate an open market for tangible goods. Initial pricing of ULR contracts are dependent upon, among other things, public comment, demand and anticipated technology adoption. Important to any thriving and liquid market, a ULR contract secondary market will be developed wherein previously purchased but unconsumed units can be resold. IPXI contemplates that ULR contract futures and derivative products will also be developed soon after the secondary market is established.

The emphasis of the ULR contract marketplace is simple: price and technology adoption are market-driven. But several emergent yet intrinsic characteristics of IP licensing make this market-driven platform the most relevant to today's need for efficiency and transparency in the technology transfer process.

Market-driven licensee benefits

The increasing demand for in-licensing is a direct product of the growing acceptance of open innovation. In essence, companies realise, now more than ever, that innovation occurs more rapidly when external R&D is used to supplement and advance internal ideas. But the lack of price discovery and transparency in the IP market constrains buyer confidence, thereby limiting the transfer of technology. The in-licensing of IP rights is frustrated by the following constrictions in the marketplace:

- **Arbitrary pricing without price discovery** – The valuation of intellectual property has never been an exact science, and without

price discovery, licensees remain concerned about overpaying relative to other licensees.

- **Unfavorable license terms on forced licensing** – Licensees remain wary that licensing terms under threat of an infringement suit may not be fair and reasonable.
- **No liquidity** – In the current paradigm, paid-up licensees shoulder a large risk of assuming the entire cost of licensed technology that may go unused if future need is reduced or corporate strategy changes.
- **Where do you find licensors?** – With no transparency in the market equipping potential licensees with transaction history data, licensees are left with the burden of seeking out relevant technology that may or may not be on the market.

Utilising a public vetting period and a Dutch auction procedure, the ULR contract marketplace provides a market-determined price for intellectual property rights on standard licensing terms. By setting an asking price for ULR contracts and lowering that price until bidders are willing to accept a minimum number of offered ULR contracts, the Dutch auction method determines an initial offering price based on market input. Similarly, later offerings of additional ULR contracts are expected to be inherently market reflexive, adapting to demand and consumption rates. Publicly disclosed consumption data provides licensees with an awareness of technology adoption rates and market growth. Finally, because ULR contracts are tradable units of technology, a liquid secondary market provides purchasers of ULR contracts with an opportunity to resell unused units.

Market-driven licensor benefits

The escalating supply of intellectual property rights for license is driven in part by the growing value of intangible assets generally and patented technology specifically. In addition, the rising cost and risk associated with R&D efforts has forced companies to recognise the following factors and benefits of out-licensing:

- **Profit maximisation** – Generally, the profit margins associated with out-licensing intellectual property may exceed 90%. This makes licensing an attractive business model to a company's bottom line, especially when the technology licensed is not core to the company's operations.
- **Cost optimisation** – Maintaining a portfolio of core patents on a worldwide basis is expensive. Revenues generated from out-licensing can offset patent maintenance costs, forced license fees, and R&D expenditures.
- **R&D output often exceeds commercialisation resources** – R&D programs frequently produce high-quality patents that are not core to operations, and hence not likely to be of strong defensive value to the company. These patents may be licensed out to cover the maintenance cost of core patents, or for profit.
- **Field of use restrictions allow avoidance of target market share dilution** – Monetisation of core patents using field-of-use restrictions outside of the core industry allow the licensor to have its cake and eat it too. In this context, a licensor may continue exploiting the technology in their target market while reaping the benefit of its use by others in non-competing markets. This flexible feature of IP licensing helps avoid market share dilution.
- **Out-licensing allows sharing of R&D risk** – r&d is both expensive and risky. the low success rates associated with both asserting and commercialising patents exacerbate this risk. Out-licensing allows for risk-sharing collaborations in order to transfer risks from a licensor's operations to the operations of an external partner firm.
- **Corporate officers and directors have a duty to maximise shareholder value.** Under an expanded interpretation of this duty, including the Delaware Court of Chancery decision in *In re Caremark Int'l Inc. Derivative Litig.*, directors may have a duty to oversee the efficient management of corporate assets with complete information. Furthermore, as IP-based shareholder activism increases, courts are becoming increasingly educated about the mismanagement of IP assets. Inefficient management of IP assets may include the maintenance of high-quality yet unexploited non-core patents, or the expenditure of excess capital on R&D without offsetting or optimising cost through available mechanisms.
- **New premium placed on collaborative ventures** – In a market in which so much corporate value is attributable to intangible assets, companies need innovative relationships with other companies to stay at the forefront of new markets. As the

legal embodiment of innovation, intellectual property rights are the safest and most efficient vehicles through which to structure such collaborations, they clearly define the rights and obligations of the parties.

Therefore, out-licensing intellectual property creates both qualitative and quantitative advantages for the licensor. The advantages are both short-term, such as profit maximisation, and long-term, such as accelerated innovation and new market opportunities.

But senior management often doesn't see the potential value that the organisation can gain through licensing. As a result, commercialising IP through out-licensing is often seen as a final option. The challenge is to transform the internal mentality away from viewing licensing as a protection mechanism to viewing licensing as a true strategic value driver. In order to license strategically, most companies must transition the licensing function from legal to R&D or another independent body. However, this shift from a cost center to a profit center has proven difficult for many companies. There is a large commitment necessary to implement the internal changes required to make licensing a strategic operation. In addition, companies often cite as inhibitory the heavy resource and time commitments necessary to effectuate bilateral licensing deals, including:

- Analysing the value and market potential for a technology;
- Identifying potential licensees;
- Determining or defending patent validity;
- Creating prospectus' and marketing materials for shopping the IP rights;
- Separately negotiating each license through one-off transactions;
- Auditing consumption and royalties to ensure correct payment; and
- Enforcing the intellectual property.

The ULR contract marketplace provides a solution to many of these concerns, making the supply of IP rights to the market an easy process. Specifically, the marketplace provides a functional platform which aids in the valuation of technology and the identification of potential licensees. Furthermore, the rulebook contemplates that the complex auditing function of a bilateral licensing program is outsourced to IPXI. The rulebook also contemplates that the high cost of enforcement may also be minimized through IPXI-internalised arbitration or the introduction of third-party enforcement funding. In addition, it eliminates most of the transaction costs causing friction in the IP market.

The new transparency and standardisation added by such a marketplace will also benefit

licensors. As stated above, the standard contracts used in the ULR contract marketplace were shaped and approved by industry-leading companies that expect to offer ULR contracts on the Exchange. Thus, the market determined fair and reasonable licensing terms providing assurance to issuers of ULR contracts that their important IP assets are protected. These terms – as well as the rulebook – are subject to member-influenced modification as the marketplace establishes itself and grows. This characteristic of the ULR contract platform exemplifies a needed dialogue between the market and its participants that has always been absent.

Summary

The above-described important market-influenced characteristics should initiate a virtuous circle: increased transparency and market pricing will cause potential licensees to experience increased buyer confidence, increasing demand and thereby facilitating adoption of the technology. Increased technology adoption should reproduce more demand, causing ULR contract purchasers to return to the marketplace. The increased demand and consumption raises revenues for the ULR contract issuer, while maintaining reasonable pricing for the ULR contract buyer. In this virtuous circle, the added efficiency and transparency of a common marketplace for the trading of IP rights benefits all parties involved.

Footnotes

1. Lemley, Mark A. and Myhrvold, Nathan, *How to Make a Patent Market* (August 2007). Stanford Law and Economics Olin Working Paper No. 347. Available at SSRN: <http://ssrn.com/abstract=1012726>
2. European Commission Call for Tender No: 3/PP/ENT/CIP/10/A/NO2S003, found at http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=4220 (last visited September 3, 2010).

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