Patent-Based Financings: Unlocking Licensing Revenue Opportunities while Mitigating Risks Associated with IP Monetization

Summary
Patent monetization has become nearly impossible for middle-market technology companies without engaging in some level of legal action. Management teams have consequently shied away from pursuing licensing opportunities, even when the revenue potential of a company’s intellectual property is compelling. While traditional debt and equity investors have an aversion to patent monetization stories, there are specialized investors willing to underwrite capital raises aimed at financing licensing revenue initiatives. By structuring these financings in a way that isolates monetization risk to the patent investor, companies can pursue licensing initiatives that have the potential to generate significant residual value for all stakeholders in the capital stack. In addition to capital, patent investors bring monetization expertise that can play a critical role in the success of a licensing revenue strategy.
Patent Licensing Offers Technology Rich Companies the Opportunity for Significant Revenue Gains

It is no secret that intangible assets, especially patents, can be a source of tremendous revenue. More than a decade ago, publications such as *Rembrandts in the Attic* brought this subject to the surface, making C-suite executives realize that companies, like Microsoft and IBM, were not the only ones capable of extracting value from their patent portfolios. New technologies have facilitated revolutions in computing, the Internet, and cellular communications, causing corporate patent portfolios to multiply. This has led to companies seeking to convert their intellectual property programs from cost centers to profit centers. By the end of the first decade of the 21st century, corporate patent licensing deals worth millions—sometimes hundreds of millions of dollars—were not unusual.

In the corporate context, patent portfolios that generate significant revenue share the following attributes: breadth, diversity, third party use and early prior dates. Breadth refers not only to the number of assets in the portfolio, but scope of coverage as well. Put simply, more patents are better than fewer patents, and scope that spans Europe and Asia is better than coverage only in the United States. A diverse patent portfolio is one that covers a plethora of technologies via different patent families. Such diversity not only guards against binary results but also presents a compelling business justification for licensing the patent portfolio. The more complex question is how much third-party usage is sufficient to warrant pursuing licensing revenue. Typically, the more patent families in a portfolio that are witnessing third party use, the higher the licensing revenue the portfolio will generate. Finally, given recent shifts in the patent world (which are detailed below), patent validity is now the central issue in defining revenue potential.

Given Recent Forms, Patent Licensing Requires Traversing a Bridge Marked by Uncertainty, Risk and Expense

Whereas corporate patent portfolios not exhibiting the prerequisites to success outlined above may periodically generate revenue, such success has become the exception to the rule. With the boom of the Internet and cloud computing, including software companies capitalizing on those technologies, the patent licensing sands have shifted. Over time, many companies began to view patents - particularly vague software patents - as weapons that could inflict significant harm in the hands of infamous patent trolls, rather than assets of potential value. Given the staggering cost of defending a patent infringement action to conclusion — easily within the $5 million range — settling was often the most rational course, regardless of a case’s merits. As the cost of these settlements began to pile up for a handful of the largest technology companies, so did the political pressure exerted on Congress to change the patent system and return leverage to those sued for patent infringement.

As most small to middle market technology companies that rely on patents to facilitate investment or generate revenue well know, change came quickly in the form of a bill that changed the U.S. patent law more significantly than any other legislation in recent history. Entitled the America Invents Act (AIA),
this legislation passed in 2011 and witnessed rollout from 2011 to 2013. In addition to reforms that made it impossible to sue many defendants in a single case, the AIA has become well-known for the slew of new proceedings it introduced in the U.S. Patent and Trademark Office’s Patent Trial and Appeal Board (“PTAB”). One such proceeding is Inter Partes Review, which gives defendants in patent litigation a parallel avenue to invalidate the patents they have been accused of infringing in district court. Unlike expensive district court litigation, an Inter Partes Review offers petitioners the chance to invalidate patents for $250,000-$300,000 on average. The PTAB is not afraid to invalidate issued patents, as they were once referred to as the “patent death squad” by the former Chief Judge for the Court of Appeals for the Federal Circuit. These proceedings have become known for their high invalidation statistics, approaching 67% of Final Written Decisions as of January 2017\(^1\).

In addition to the Congress, the Courts have also made life difficult for patent holders in recent jurisprudence. First, the Supreme Court in eBay Inc. v. MercExchange, LLC made it significantly more difficult for patent holders to obtain injunctions as a remedy for patent infringement. Some years later, in its Alice Corp. v. CLS Bank Int’l and AMP v. Myriad Genetic, Inc. decisions of 2013 and 2014 respectively, the Supreme Court cast an extreme shadow over the validity of many software and medical diagnostic patents. These collective developments, combined with judicial trends of knocking down plaintiff damage theories, have made it significantly more difficult for patent holders to reach the proverbial pot at the end of the rainbow. This difficulty cannot be overstated.

Like any finely tuned equilibrium that experiences a sudden disruption, today’s patent market remains not only in flux, but markedly changed for those companies seeking to generate revenue through patent licensing. Simply put, the patent revenue generating strategies that used to work no longer do. It is no longer sufficient for a company to hold quality patents and expect that business discussions will result in patent licensing deals, albeit priced at a discount to what litigation may have yielded.

Given the leverage shifts that accompanied the most recent patent reforms, the courtroom, rather than the boardroom, is now the avenue through which patent licensing deals are achieved. Seemingly inefficient, yet true. Put simply, because defendants no longer face injunctions, have a statistically higher chance of invalidating patents via the relatively low cost avenue of Inter Partes Review and typically do not face putative measures in the event of a litigation loss, the incentives to voluntarily pay licensing fees in the absence of litigation threat do not exist.

Case in point: Ericsson, the owner of thousands of patents, announced a patent licensing deal with Apple at the end of 2016, but not before filing a cadre of lawsuits against Apple, both domestically and abroad. Even Ericsson’s vast patent portfolio was not enough to strike a deal with Apple without litigation; nor is Ericsson’s experience unique in today’s environment. Patent licensing deals can still contribute millions, if

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not hundreds of millions of dollars, to a company’s revenue, but not before the filing of one, or many, patent infringement lawsuits to drive the requisite licensing deals.

Given the dynamics of today’s patent environment, two primary factors dominate a patent owner’s quest to create licensing revenue: expense and risk. The expense is the direct result of the fact that litigation is now required to conclude patent licensing deals. A single patent litigation run by a reputable law firm can cost upwards of $5 to $7 million. Multiple suits, including suits brought abroad, will only further multiply the expense. The risk predominantly flows from the extremely high invalidation rates seen in Inter Partes Review proceedings. Even where a patent initially survives an Inter Partes Review, it is likely to be serially challenged, with new prior art, from any party with an interest in seeing the patent invalidated.

Nor is the avenue historically available to patent owners to assuage the risk and expense of patent litigation — leveraging contingency legal counsel — a realistic option in the current environment. Whereas reputable patent holders seeking to control litigation costs could typically rely on legal counsel working on partial or full contingency, this is no longer the case. Given the increased costs and risk introduced by recent patent reforms and judicial decisions, it is the rare firm management committee that will approve a case on significant contingency. Instead, and particularly for small to middle market companies, a new paradigm is needed to pursue patent licensing revenue, while at the same time controlling, for the risk and expense of doing so. After all, and above all else, the income statement must be protected.

Finally, it is important to recognize that risk is not confined to the litigation context, but also now permeates patents generating ongoing licensing revenue. In many contexts, licensing revenues will only persist so long as the underlying patents remain valid. Increasingly, however, licensees and strategic third parties seek to invalidate patents in Inter Partes Review, rather than continue to pay or renew patent licenses. The uncertainty of future revenue streams further justifies financing structures that ameliorate such risk.

Fortunately, companies with an interest in pursuing patent licensing revenue, while at the same time sharing the risk and substantial expense of doing so, have a relatively new option: patent-centric specialty financings. Offered by investors with an expertise in patents and monetization, these financings can take many forms, including recourse and non-recourse litigation finance, equity investments and/or the purchase of existing or predicted royalty streams or pending judgments. Returns are typically tied to the performance of the underlying intellectual property, rather than corporate performance. In the litigation context, investment returns are typically tied to settlement, licensing or damage proceeds generated via litigation. In the royalty monetization scenario, the investor purchases the rights to some, or all, of a future royalty stream, at the appropriate risk weighted discount. Through these financings, patent rich companies
seeking to drive substantial patent licensing revenue now have an avenue to offload the meaningful risk and substantial expense, which has become inherent in the corporate patent licensing process.

However, the market for these financings is not transparent. Although significant capital is available for deployment to support corporate patent licensing, many such deals, as well as structures and terms, remain highly confidential. In general, based on our significant experience both in deploying and advising companies regarding patent-based financing, most deals share several characteristics. First, while the amount of capital available for a particular deal may have no limit if the size, diversity and breadth of the opportunity justify the investment, most investors in the space prefer minimum investments of at least $3 million (USD). Second, the returns in such financings are typically tied to the performance of the underlying intellectual property, with the financier seeing all or a portion of invested capital as first money out, with the remaining funds being shared by the financier, patent owner and law firm, where appropriate. Third, the potential returns typically increase with time, therefore the financier will have more participation in a licensing deal that occurs in year five of the investment, as opposed to year one.

Rather than focus on the similarities, corporations seeking any form of patent-centric specialty finance should consider the differences among such investors, as well as the financings they offer. Three important considerations for any corporation considering such financing are (1) the financial position of the investor; (2) the proposed deal structure; and (3) the patent expertise of the potential financing partner.

Financial Position
In today’s environment, a host of entities ranging from individuals to institutions, purport to offer patent-centric financings, particularly litigation finance. From the inception of any potential relationship, Corporations seeking such financing should confirm that the potential financier does in fact possess or manage its own underlying funds. Indeed, numerous entities purporting to offer such financing do not, in fact, possess the capital and rather act as middlemen, seeking the necessary capital after an indication of interest from a given company. Above all else, such relationships can create significant impediments to closing deals, let alone doing so in an expeditious manner. In addition, the capital typically becomes more expensive, as more than one party is now sharing in the proverbial pie. Finally, the opportunity for a true value-added partnership, the importance of which we describe below, is often lost.

Deal Structure
The next crucial consideration for any company seeking patent-centric finance is the structure of the deal. A constant in these varieties of financings is the significant idiosyncratic risk borne by the investor, resulting in a cost of capital that is greater than in traditional financings. For this reason, companies should consider patent-based capital raises in isolation from their broader capital structure decision process. That is not to say that patent-based financings constrain the use of capital to patent monetization. In fact, a well-structured capital raise will allow a company to deploy at least some of the new funds for general
corporate purposes. However, because of their inherent cost of capital, companies should assess patent-centric financings in direct correlation to the expected revenue opportunity from monetizing intellectual property. By viewing patent financings in this light, companies can often structure non-dilutive structures favorable to other classes of security holders.

Overall, while there remains considerable variation in deal structures among different investors, any deal should seek to adequately align the incentives of the investor, patent owner and legal counsel. For instance, particularly high value patent licensing deals are often not seen until significant litigation success has been achieved. In a situation where the investor with returns tied to litigation outcomes is entitled to various multiples of invested capital before patent owners have had the opportunity to share in the recovery, patent owners then lack the necessary incentives to resolve cases at earlier points, even if settlement opportunities arise. These missed opportunities for revenue may prove highly disadvantageous for patent owners.

**Value-Added Partner**

Finally, it is crucial for companies interested in any form of patent-centric finance to remember that such financings create an opportunity for a value-added partnership between the investor and recipient company. Some financing entities are novices in patents, patent licensing and/or patent litigation, offering little opportunity for a collaborative, value-added partnership subsequent to the closing of any deal. Other entities, however, are true experts in not only financial matters, but patents and litigation. This expertise is ideal in a number of respects. For instance, only with the appropriate expertise is it possible to assign the appropriate risk to an opportunity, the calculation of which directly determines the appropriate cost of capital. In addition, those investors with a deep understanding for the complexities of the underlying intellectual property offer the opportunity for substantive advice on a host of nuanced patent issues after closing. Due to the extensive patent due diligence involved in these financings, the mere involvement of a well-regarded patent investor generally serves as a strong signal to Wall Street regarding the quality of a company’s intellectual property.

**When Should Companies Explore Patent-centric Financings?**

In summary, companies can generate new revenue opportunities by unlocking the value embedded in their patents. Doing so inevitably requires some degree of legal activity, whose expenses and risks can be partially off-loaded to patent investors. In addition to capital, patent investors bring essential monetization expertise that companies can leverage to accelerate their licensing revenue opportunities. When traditional debt and equity capital sources prove unwilling to support a company’s patent monetization opportunity, patent-centric financings can provide the right economic solution despite their potentially steep cost of capital.
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