

FOCUS

Winning in the Evolving Marketplace of Ideas

Intellectual Property Strategy for the Twenty-first Century



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Patents were created to promote innovation by granting inventors exclusive rights to their inventions. For the past 200 years or so, the market for trading intellectual property (IP) was relatively tame, with understandable rules of engagement among IP owners. But in the twenty-first century, the IP market is becoming both more uncertain and more hazardous, in part because a new breed of owner has burst onto the scene.

Nonpracticing entities (NPEs), which acquire and monetize IP, have helped to raise the risks for companies that actually produce goods and services. NPEs have been around for a few decades but have become increasingly sophisticated and well capitalized. Twenty years ago, an individual inventor or contingency-fee lawyer would hope to strike it rich by asserting a single patent. Today, NPEs tend to be funded by investors who expect private-equity-like returns. NPEs are building sophisticated licensing and assertion strategies around high-quality IP. These companies filed 295 or more lawsuits in each of the four years from 2005 through 2008, representing about 12 percent of all U.S. patent litigation in 2008. (See Exhibit 1.)

In one of the most publicized cases, BlackBerry purveyor Research in Motion settled with NTP for \$613 million. While NPEs have focused to date on technology companies, they are increasingly targeting other industries, such as medical products, pharmaceuticals, and industrial goods.

NPEs are often referred to pejoratively as “patent trolls” because they do not themselves produce their patented inventions but instead extract a licensing fee from those that do. This criticism, however, misses the point. A patent does not imply any obligation to make, use, or sell the invention. Today, Thomas Edison would be a troll.

More broadly, IP is an evolving asset class whose value is increasingly determined by NPEs and other players in an emerging market. NPEs frequently are more sophisticated and place a much higher value on IP assets than do traditional IP owners.

They have raised the stakes for all companies with IP assets. Companies that want to maintain their freedom to operate and innovate need to strengthen their use of IP as a strategic weapon against competitors and as a shield against attack.

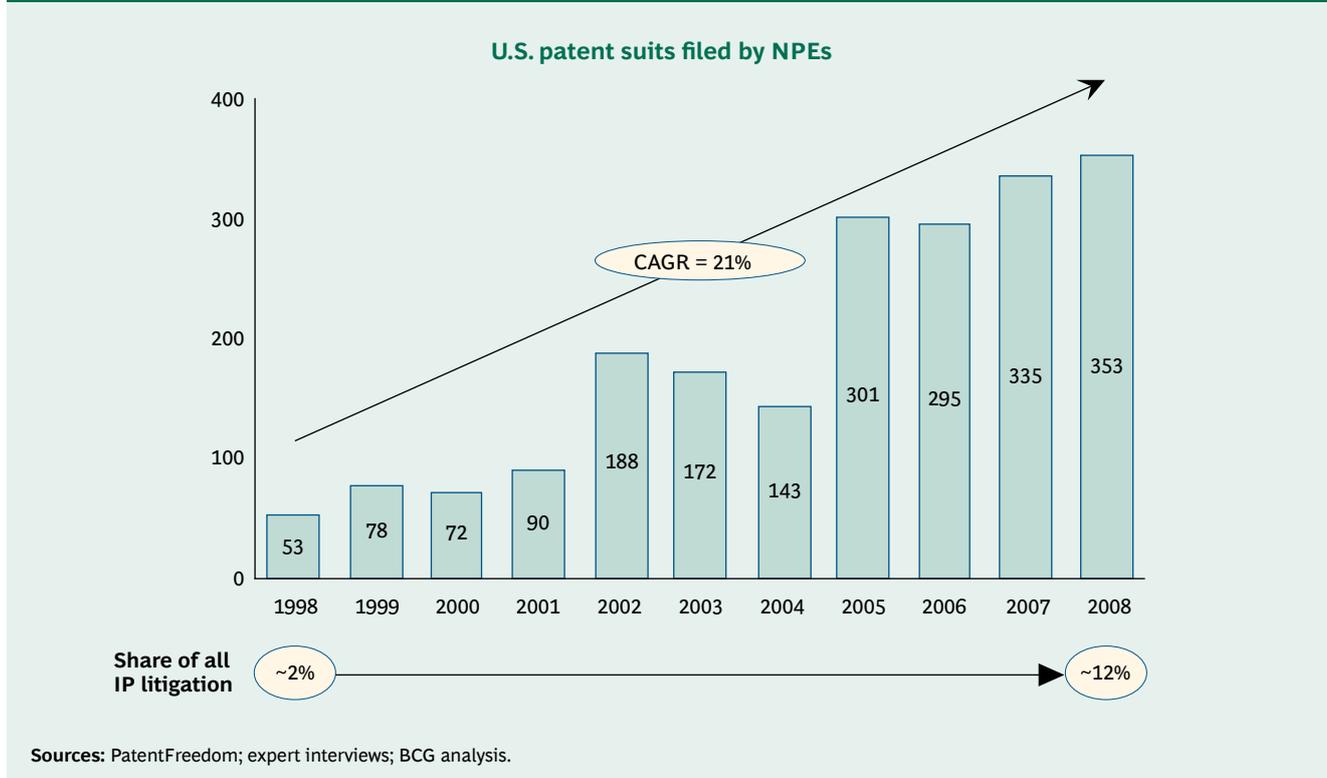
The Evolution of the IP Market

The foundation of today’s IP regime was laid in the last two decades of the twentieth century. Its cornerstone is the U.S. Court of Appeals for the Federal Circuit, created in 1982 to hear all patent appeals. The court extended patent rights into new areas, such as business methods and biotechnology, and harmonized case law. Many traditional companies, particularly in the pharmaceutical and technology arenas, have taken advantage of the more favorable and consistent IP environment that resulted. IBM, for example, has generated more than \$1 billion in annual licensing revenue for more than a decade from its patent portfolio.

During this period, the U.S. Patent and Trademark Office has become buried in applications. The number of patent filings increased nearly fivefold from 1985 through 2009, leading to the issuance of many overly broad, questionable patents.

The dot-com bust in 2001 further drove up the supply of technology patents available to buy at a discount. The increase in the supply and reach of patents provided ammunition for NPEs.

Exhibit 1. NPEs Are Filing More Patent Suits



This perfect storm of courts and capitalism fueled the rise of NPEs and the development of an increasingly robust ecosystem, comprising the following stakeholders, to facilitate and support the trading of IP assets:

- ◇ Entrepreneurial lawyers, who finance legal challenges by taking cases on contingency and who manage the litigation
- ◇ Institutional investors, who fund NPEs and increase the demand for IP assets
- ◇ Inventors and university technology-transfer offices, which provide a supply of IP assets to the market
- ◇ IP advisors and brokers, who perform valuation and due diligence

and unite buyers and sellers in the opaque IP market

IP assets are increasingly valued and traded like other tradable asset classes, as investors and specialists inject liquidity into and impose standardization on the market. The market for traded IP grew at 40 percent annually from 2003 through 2008, before falling off during the recession in 2009.

Intellectual Ventures—which does not consider itself an NPE, because it finances and conducts long-term research—has raised \$5 billion and holds a portfolio of more than 30,000 patents concentrated in the technology, media, and medical sectors. It has collected more than \$1 billion in licensing revenue without ever filing

a lawsuit. In a recent article in *Harvard Business Review*, the company's founder, Nathan Myhrvold, compares his company to the early venture capitalists.¹ Myhrvold, a former chief technology officer at Microsoft Corporation, writes that his company and others will “turbocharge technological progress, create many more new businesses, and change the world for the better.”

Some traditional companies have taken notice. In the early days of the market's rapid evolution, from 2000 through 2004, most of the sellers of IP assets were distressed companies, and most of the buyers were NPEs. These days, according to BCG's anal-

1. See “The Big Idea: Funding Eureka!” *Harvard Business Review*, March 2010.

ysis, up to one-quarter of sellers are healthy companies, and about 40 percent of buyers are operating companies rather than NPEs. Healthy companies are selling patents in order to generate revenue, or they are buying patents that might otherwise fall into the hands of NPEs.

A few “defensive” patent aggregators have also recently formed. They are typically funded by groups of operating companies, and they buy potentially dangerous IP as a form of protection against patent litigation.

But the lines are blurring. RPX Corporation, the largest of these companies, has pledged not to sue companies directly with any IP it acquires, but it may sell patents to other parties that will.

The rapidly evolving market for IP is still dominated by a relatively small—but growing—group of insiders. Operating companies may find it difficult to break into the club unless they invest now to get up to speed.

The IP Journey

The evolution of intellectual property has changed the nature of IP strategy. In the 1990s, IP strategy was generally passive. Companies would build a patent portfolio as a shield against competitors. If the portfolio was sufficiently large, competitors would be unlikely to sue because of the risk of a countersuit.

In some industries, such as IT, competitors frequently entered into cross-licensing agreements as a way to limit their liability and ensure design freedom. Few companies were actively trying to maximize the return on their IP assets.

Today, executives in charge of innovation must actively establish their freedom to innovate through strong IP practices. Chief strategy officers want to develop barriers to entry in key markets—which patents, providing exclusive rights, can offer. Chief

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financial officers want to both minimize the risk of costly IP verdicts and settlements and maximize their licensing revenue from noncore IP assets.

These motivations—along with the threat of litigation from NPEs and competitors—give companies a compelling reason to manage their IP strategically. There are five steps that will help companies develop a greater IP presence. (See Exhibit 2.) Many companies are taking parts of some of these steps, but few have mastered all five.

Create. Companies need to align their IP strategy with their innovation and corporate strategies in order to stake out the freedom to operate in both existing and future markets. Many companies, for example, now embed their IP team more tightly into the ideation and product development process. At each major product-development milestone, the status of IP protection and the implications of IP developments are discussed. As a result, these companies are able to identify key gaps in their IP portfolio and then close them through patenting, purchasing, or li-

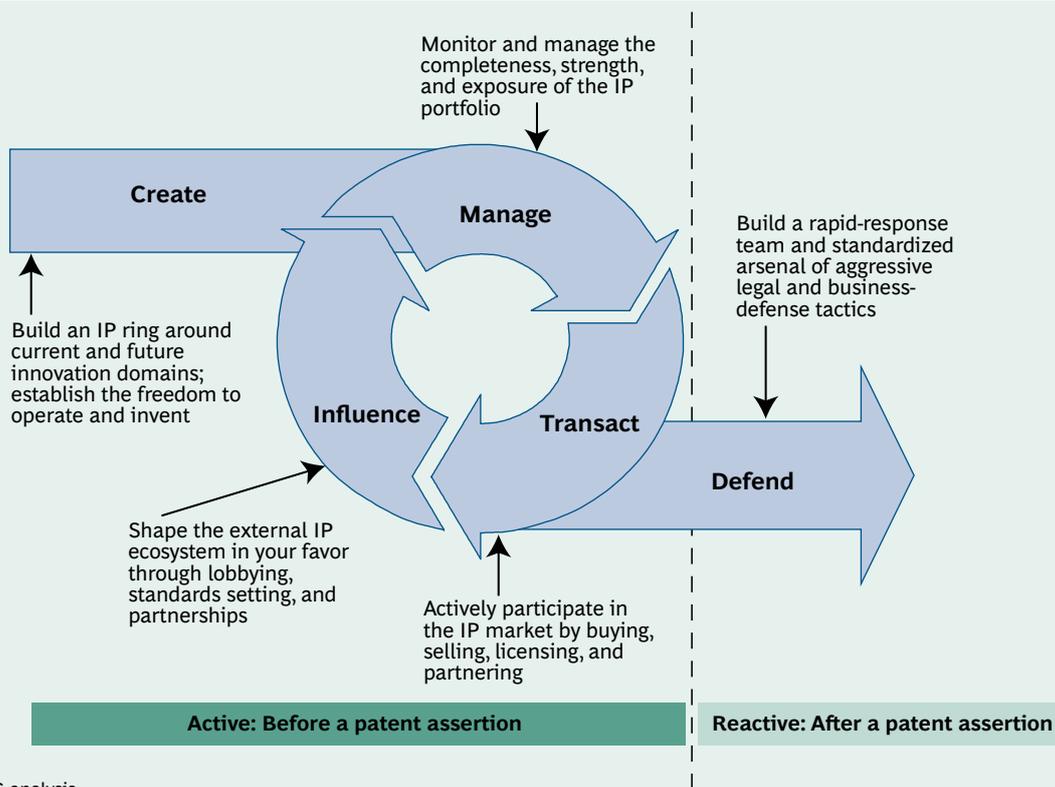
censing. This exercise should go beyond the current pipeline to consider future sweet spots.

Manage. NPEs are actively managing their portfolio of IP assets, and so should operating companies. Some companies have developed a small, dedicated group of IP specialists with both legal and business backgrounds, along with in-house IP-monitoring systems to gather market intelligence about the activities of NPEs and other IP owners. IP specialists can help companies understand the strengths and weaknesses of their IP portfolio and look for ways to fortify and generate revenue from it. They should be in frequent contact with the product development, business development, and legal teams and have access to senior executives.

Some companies are creating IP holding companies to maximize the value of these assets, while others have begun exploring creative arrangements with NPEs. Sony and Philips, for example, purchased InterTrust Technologies Corporation after it successfully asserted digital-rights-management patents against them; the company has since won profitable licensing fees from several companies.

Transact. It is impossible to be a credible player in the IP ecosystem without participating in it as an active buyer and seller. A company’s in-house IP specialists should develop relationships with brokers and other agents who can alert them when potentially dangerous or valuable patents become available. These relationships are crucial because brokers will offer IP assets to proven buyers first. The IP team also needs to have a budget and the

Exhibit 2. The Best Defense Is a Strong, Proactive IP Strategy



Source: BCG analysis.

power required to make decisions quickly.

Influence. The most sophisticated IP companies can try to tilt the IP playing field in their favor. While fundamental patent reform in the United States is unlikely, companies can take other steps to make life more challenging for NPEs, such as boycotting their law firms or promoting open standards that do not rely on proprietary IP. In Europe and the developing markets, where business and government frequently have close ties, there may still be opportunities to influence IP regulation and law in favor of operating companies.

Defend. Mastering the preceding four steps and developing a well-

thought-out IP strategy can minimize the threat of litigation but not entirely eliminate it. IP litigation is expensive, risky, and uncertain. Cases that go to trial can cost tens of millions of dollars. In many jurisdictions, winning plaintiffs can enjoin the defendant from making, selling, or using the infringed products.

Sophisticated companies have established rigorous processes—and centralized teams—to quickly evaluate incoming patent assertions based on the strength of the asserting company and its claim. They create triage systems to treat the highest-risk threats with urgency. They also have guidelines laying out when it is preferable to engage in full-scale litigation, test the validity of patents in

pretrial skirmishes, settle nuisance claims, or take some other action.

The First Step

It takes time to create, manage, transact, and influence. But defending against IP attacks can start immediately. The following questions may provide an initial road map:

- ◇ How does the strength of your IP protection of key products and services compare with that of your competitors? Where are the gaps? Where are you most at risk?
- ◇ Which distressed companies hold patents that would pose a risk were they to fall into the hands of an NPE?

- ◇ Do you have a clearly defined process for responding to patent assertions?
- ◇ Do you have a strong defensive program with a preapproved budget to buy patents? Can you make IP licensing or purchasing decisions quickly? Do you have strong relationships with the leading IP brokers?

- ◇ Have you started a licensing program in order to generate revenue to offset the cost of defending against patent assertions and paying off NPEs?

If necessity is the mother of invention, the NPE threat may give birth to a new wave of strategic creativity as the initial focus on defense shifts to offense. IP is an increasingly im-

portant driver of competitive advantage, yet too few companies explicitly consider IP in the development of their broader strategies. An IP strategy is highly valuable on its own, but when fully integrated into business strategy, it has the potential to change the game. By now, the risks and opportunities should be patently obvious.



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