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Risk management: a focus on intellectual property

BY ROSS PETTERSEN, JEFF SNELL AND BRIAN FRIZZELL

The news is filled with stories about how intellectual property (IP) can dramatically affect company value—from patent infringement lawsuits to blockbuster drug patents expiring to small companies with little more than IP being sold for large amounts. However, while companies devote significant time and effort in the management of their physical assets, they typically devote much less time and effort managing their IP assets. This situation, taken to its extreme, is a risk management problem and provides a framework for effective management of IP assets and related risk.

Need for IP risk management
An increasing and significant portion of company value is attributable to its IP, and these IP assets are subject to substantial risk. To demonstrate that IP is an increasing and significant portion of company value, we examined the value of intangible assets at two points in time for the 30 companies comprising the Dow Jones Industrial Average (DJIA) using a commonly used metric for estimating the value of intangible assets in the market-to-book ratio. Intangible assets include IP assets, such as patents, trade secrets, trademarks, licenses, and goodwill, as well as employee knowledge and other types of assets that do not appear on the balance sheet. Although it is difficult to measure directly, IP assets often comprise a large portion of a company’s intangible assets.

In 1985 the average market-to-book ratio for companies comprising the DJIA was approximately 2.1, suggesting that intangible assets represent approximately 52 percent of company value. In 2005, the market-to-book ratio for companies comprising the DJIA was approximately 3.0, suggesting that the value of intangible assets has grown significantly. One component of IP risk is dramatic litigation risk. IP litigation can be quite useful in IP-related cases. For example, IP-savvy companies sued for patent infringement often sue a competitor’s products and IP positions, and IP litigation and injunction history. This initial assessment is the first step in the IP risk management framework, which is illustrated in the graphic below. The initial assessment is then followed by an operational phase to understand the processes and tools and the company has in place to manage IP risk. The third phase consists of strategy development, including a gap analysis, in order to create a roadmap from the status quo to implementation of leading practices in IP risk management.

IP risk management process
There are numerous tools that companies can use throughout the IP risk management process (see Figure 1). IP asset databases, customisable contract management databases, IP analytics tools, valuation template libraries, and litigation risk analysis templates, to name a few. Other areas where these tools can be quite useful is IP litigation. Early in the litigation process, companies should identify, quantify, and manage their risk. In some instances, litigation risk analysis helps defendants settle cases before incurring substantial legal fees. In other instances, litigation risk analysis helps plaintiffs identify situations where substantial litigation costs are warranted due to the potential for significant damages awards.

Another area where these tools are effective is in licensing. In developing licensing strategies, companies can use flexible licensing models that measure the estimated benefits of their IP to potential licensees, assisting in the development of a comprehensive strategy for extracting maximum value. These tools can also be used to prioritise licensing targets, understand potential license structures, and prioritise licensing activities. Additionally, these tools may also be used to conduct sensitivity and scenario analyses based on varied assumptions regarding possible strategic outcomes and royalty structures.

IP risk matrix
IP risks can be segregated into threats and opportunities and then further segregated into potential threats to its business, but it should also include potential opportunities. For example, IP-savvy companies sued for patent infringement often sue their own portfolios in order to identify patents that might provide the basis for a counter lawsuit. Companies with well managed IP portfolios often look for opportunities to license their technology in non-competitive markets. For some companies, recognising IP opportunities can be the difference between success and failure. The following is a discussion of how Cytomedix, Inc. (Cytomedix), a biotechnology company, developed a licensing strategy to success. Cytomedix is a biotechnology company specialising in the research, development, licensing, and distribution of systems for regenerative medicine (Figure 2).

To elaborate on an example from the IP risk matrix, the following describes vendor litigation and injunction risk. In November 2001, NTP Inc. (NTP) filed a patent infringement suit against Research in Motion (RIM), claiming that one of RIM’s BlackBerry wireless communication devices infringed NTP’s patents. The litigation threatened to shut down BlackBerry service to millions of users in the US by obtaining an injunction from the court. As a result, companies that relied on BlackBerry service to run their businesses faced the risk of business interruption had an injunction been enforced. Ultimately, RIM settled the case for $621.5m, avoiding a shutdown of its service.

IP risk case study—Cytomedix
A company’s view of IP risk should not be limited to potential threats to its business, but it should also include potential opportunities. For example, IP-savvy companies sued for potential infringement often sue their own portfolios in order to identify patents that might provide the basis for a counter lawsuit. Companies with well managed IP portfolios often look for opportunities to license their technology in non-competitive markets. For some companies, recognising IP opportunities can be the difference between success and failure. The following is a discussion of how Cytomedix, Inc. (Cytomedix), a biotechnology company, developed a licensing strategy to success. Cytomedix is a biotechnology company specialising in the research, development, licensing, and distribution of systems for regenerative medicine (Figure 2).

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Figure 2 – IP Risk Matrix

To date, Cytomedix has announced patent licences with several major medical device manufacturers, including Biomet, DePuy of Johnson & Johnson, and Greatbatch. These licences have generated several millions in upfront royalty payments, which have been used to support Cytomedix’s continued capital expenditures for product development and marketing efforts in Cytomedix’s core markets. Specifically, Cytomedix has developed a licensing initiative focused on licensing its patented technology exclusively to non-market companies in the core-care markets, while trying to reserve for itself and its AutoGel formulation the ‘core chronic wound care’ markets.

Conclusion
IP may be the most valuable class of asset a company owns. Accordingly, companies need to: (i) inventory their IP assets and concurrently assess their IP risk; (ii) identify and implement management of IP; and (iii) develop processes and tools to enable a more proactive management of IP risk. Such a process will enable companies to not only better manage IP-related threats, but also to exploit IP-related opportunities, resulting in increases to shareholder value.

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Need for IP risk management

An increasing and significant portion of company value is attributable to its IP, and these IP assets are subject to substantial risk. To demonstrate that IP is an increasing and significant portion of company value, we examined the value of intangible assets at two points in time for the 30 companies comprising the Dow Jones Industrial Average (DJIA) using a commonly used metric for estimating the value of intangible assets. This number increases to $5.2 trillion in a 2003 AIPLA survey. Other statistics from US courts show that it takes 20 months on average for a patent infringement case to reach trial, resulting in a significant period of uncertainty for the company, customers, and any other party that uses the value of the patents. The increasing number of issued patents, the large potential damages awards, the high cost and long duration of IP litigation, and the emergence of companies that exist solely to enforce patent rights suggest that IP litigation is something that companies must address.

The prior discussion demonstrates that IP risk is both significant in terms of size of potential impact and in relative frequency of events. The evidence indicates a company places a substantial amount of value at risk if it does not proactively manage IP risk.

IP risk management framework

How are companies supposed to manage, or even identify, potential IP risks? A company should establish a framework to manage the risks associated with IP. Such a framework often starts with an initial assessment of the market-to-book ratio. Intangible assets include IP assets, such as patents, trademarks, and copyrights, and trade secrets, as well as intangible assets, such as the value associated with customer relationships and human capital.

In 1985 the average market-to-book ratio for companies comprising the Dow Jones Industrial Average (DJI) was approximately 3.6, suggesting that IP was an increasing and significant portion of company value. This number increases to $5.2 trillion in a 2003 AIPLA survey. According to government statistics, there were 17,273 patent infringement lawsuits initiated in 1995. In 2005, this number increased to 28,292, for an increase of 64 percent in just 10 years.

IP risk management framework

In order to manage the risks associated with IP, companies must: (i) proactively manage IP risk; (ii) identify and manage potential threats; and (iii) incorporate IP risk into overall business strategies.

IP risk matrix

IP risks can be segregated into threats and opportunities and then further segregated into threats and opportunities associated with competitors and customers, as well as with non-competitors. These license deals not only fund the company’s operations, but also enhance the ability to develop new products. The management team viewed licensing as a significant potential threat to the company’s business, but it also identified the potential opportunity for licensing to a third party and obtaining a share of the revenues.

Conclusion

IP may be the most valuable class of asset a company can own. Accordingly, companies need to: (i) inventory their IP assets and concurrently assess their IP risk; (ii) identify potential threats to the management of IP, and (iii) develop processes and tools to enable a more proactive management of IP risk. Such a process will enable companies to not only better manage IP-related threats, but also to exploit IP-related opportunities, resulting in increases to shareholder value.
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