AMERICAN BANKRUPTCY INSTITUTE

JOURNAL

Issues and Information for Today's Busy Insolvency Professional

Obtaining Maximum Value from Distressed Patent Assets

Two Cases of Unlocking Millions in Overlooked Patents

Written by:
Ron Epstein
IPotential LLC; San Mateo, Calif.
ron@ipotential.com

Michael Pierantozzi
IPotential LLC; San Mateo, Calif.
michael@ipotential.com

One of the best-kept secrets in the technology industry is that patents are frequently ignored or overlooked in distressed-business situations. This is particularly surprising considering that, for technology companies, intellectual property (IP) typically represents the core value of the business. Five years ago, this failure to appreciate the value of patent assets was understandable. Now, however, there is an increasingly active market for patents, giving owners of distressed companies and their creditors the ability to use the patents to derive value.

Emerging Patent Marketplace

As recently as five years ago, there was very little interest in the purchasing of technology patents. Today, there is a burgeoning and growing market for these assets, fueled by billions of dollars worth of active buying from both operating companies (motivated for defensive and strategic purposes) and financial investors, such as hedge funds and special-purpose entities that look at patents as an asset class that is capable of delivering significant financial returns. Despite the increase in patent buying, the market remains extremely inefficient, in part because it is hard to identify appropriate potential buyers since many are reluctant to advertise their interest, and in part because determining the value of a patent as an asset is a complex task that requires access to significant and often nonpublic information and expertise.

About the Authors

Ron Epstein is co-founder and CEO and Michael Pierantozzi is vice president of Corporate Development of IPotential LLC, an IP advisory and transaction services firm in San Mateo, Calif.

As the patent market has been taking root, we have been approached by companies and individual inventors seeking to get value for their patents in order to generate cash to return to their creditors and investors. With the recent economic upheaval and requisite reduction in the availability of financing at acceptable rates, we have also seen an upsurge in distressed companies looking to realize immediate cash from their patent assets as a last-ditch source of funding.

Feature

Many of these distressed companies had quality patents that had a significant market value, and some even had fundamental patents on one or more technologies that had been broadly adopted by the market. In fact, some of the most valuable patent portfolios we have seen have come from companies going through dissolution. This is not all that surprising in retrospect; real innovators with meaningful inventions are by definition first to market and often are too early to achieve and maintain financial viability.

Presented in this article are two case studies from recent patent sales that exemplify key factors that are often overlooked by owners, creditors and insolvency professionals as they seek recovery. The first case occurred in bankruptcy, while the second case occurred as the company tried to avoid bankruptcy.

Patent Sale Case Study 1: Pilot Network Services Inc.

Pilot Network Services Inc. was a publicly-traded technology company in California's Silicon Valley. Founded in 1992, the company was a pioneer in Internet security and specialized in providing commercial Web hosting and access with enhanced protection against cyberattacks. To protect its competitive advantage, Pilot sought and was granted a fundamental patent on the concept of programmable firewalls.

Despite its apparent success from innovation for over a decade and a half, the market changed and a combination of increased low-cost competition and a decrease in overall demand for its outsourced services challenged the company. In March 2007, the company liquidated in chapter 7. The trustee worked successfully to liquidate the company's assets and distribute the proceeds among the company's creditors, but the company's patent was overlooked in this process.

After the bankruptcy process had been officially completed, the senior secured creditor, Bank of America, received an unsolicited offer for \$100,000 from the attorney representing an anonymous buyer for Pilot's patent. Bank of America's IP Legal Department performed a preliminary assessment of the patent and realized that the offer was not commensurate with the potential market value of the patent. The bank then contacted the trustee and informed her of the offer and the preliminary analysis of the patent.

The broker, quickly assessed that the offer was too low and explained two key factors that are required in any patent sale to get the best price: (1) the patent must be used (*i.e.*, infringed) by companies; and (2) there must be significant sales of the products that use the patented invention.

Assessing these two factors is a complex analysis that requires legal and technical expertise, as well as experience in the IP transactional market. In Pilot's situation, the analysis demonstrated that the patent should be able to generate substantially more than the initial offer since it covered programmable firewalls, an early and important feature included in nearly every product that provides firewall protection for today's networks (such as routers, switches and nearly all wi-fi hubs), a multi-billion dollar industry.

Armed with this information, the trustee petitioned the assigned judge from the U.S. Bankruptcy Court for the Northern District of California to reopen the case for the purposes of transacting the patent sale. The court reopened the case.

The broker knew that potential buyers would need to be informed of the opportunity and given adequate time to analyze the patent, both legally and technically before submitting bids. The broker, through the trustee, requested an extended process that would allow for a three-month period for buyer identification and due diligence. As a result of this extended process, prospective buyers who might have an interest in acquiring the patent would be (1) informed of the patent sale, (2) given detailed information that would allow them to evaluate the patent's true value and sufficient opportunity to complete their own due diligence on the patent, and (3) able to participate in a transparent process that would allow both the bidders and court to have confidence that the bidding was fair.

As a result of this process, the broker informed more than 100 potential buyers of the opportunity and then negotiated bids from more than a dozen interested parties. After a detailed bid and over-bid process was conducted, the patent was sold for $1 million, more than *10 times* greater than the initial bid the trustee almost accepted.

Patent Sale Case Study 2: LongBoard Inc.

LongBoard Inc. was a pre-IPO, Silicon Valley company founded in 2000 by two telecommunications industry veterans with the goal of driving the convergence of voice and data networks. While companies such as Lucent and Cisco were trying to understand how to convert the telecommunications' backbone to IP, LongBoard was bringing Voice-over-IP (VoIP) telephony to the desktop. More than two years before Skype was founded, and several years before companies like Comcast brought VoIP phones into the home, LongBoard filed and was later granted some very early and basic patents on the VoIP telephone.

LongBoard found itself ahead of the market demand curve in 2006, resulting in sales revenue falling below plan. After a year-long unsuccessful attempt with an investment banker to seek sale of the company, the responsibility for pushing the company forward fell back to the lead investor. By early 2008, the company found itself in an unfortunate financing situation after exhausting its equity and an additional $5 million in bridge financing, and the investors decided to wind-up the company.

While undergoing this wind-up process, LongBoard received two unsolicited offers to purchase its patent portfolio. Each offer was for approximately $1.5 million—one offer from a patent investor and the other from an operating company with which LongBoard had previously engaged in acquisition discussions. Initially, the board leaned toward accepting one of the current offers, but ultimately decided that while they were willing to sell the patent portfolio for $1.5 million, if that was the fair price, they did not want to let the asset go substantially below market value. Their key problem, with no experience in selling patents, was that they did not know how to determine if these competing offers were fair.

As the board considered giving the two initial bidders one more chance to overbid and close the purchase, the broker completed its initial infringement analysis on the patents and found that several of the patents contained claims that were widely adopted by VoIP service providers and equipment manufacturers and, as such, should command prices much higher than was currently being offered. The broker brokered the sale of the patents and ended up dividing the portfolio. It was sold it in two lots, each to a different buyer, through an active M&A-like sales process. In less than five months, LongBoard obtained $5,375,000 from the sale of the patents—almost $4 million more than the original "good offer" that the initial offer. While that result was significant in itself, the increased price allowed the company to return nearly all of its $5 million in bridge financing.

As both cases highlight, to get the best result from the sale of patents, creditors need to quickly get into a multiple-bidder position. Unlike most other assets where insolvency professionals can target a well-defined set of buyers or markets to yield good results, patents present unique challenges that only patent-transaction experts are uniquely equipped to handle.

Creditor's Dilemma with Patents in Bankruptcy

Investors in any technology company understand how patents and other IP developed by the company represent some of its most valuable assets. However, when a company becomes insolvent, trustees, attorneys and other bankruptcy experts have a tendency to generalize IP into familiar category types including trademarks and copyrighted works such as books, music and video content. Surprisingly, recovery value in these over-simplified categories has satisfied many unaware creditors. Patents are complex and unique types of IP, whose value varies considerably based on issues like the existence of infringement, validity and clean title, and typically fall beyond the expertise of most bankruptcy professionals.

As illustrated in both cases, informed patent owners have a clear and simple objective: to get the best price possible for the patents in a timely manner. To achieve this objective, these creditors are increasingly seeking help from a new class of IP transaction firms that specialize in getting the full market value for their patents.

These firms provide patent owners with a detailed understanding of the value of their IP portfolio (*e.g.*, patent claims) in the context of their business and technology investments. Most importantly, these firms have access to interested buyers and critical know-how to provide the necessary information to complete the patent sale transaction, typically at a price beyond the expectations of the owner. In many cases, IP assets are established as some of the most valuable remaining assets in a distressed company.

Patent buyers determine value by answering certain complex questions in their due-diligence process. However, potential buyers face a number of obstacles in answering these questions, such as:

- most buyers do not buy patents in technology areas where they own filings;
- answering these questions often requires difficult-to-obtain information such as proof of current use, existence of prior art, existence of past licenses, etc.; and
- existing methods to answer these questions are expensive, typically requiring lawyers and other experts.

A successful patent broker will develop substantial marketing packages containing much of the critical information (*e.g.,* demonstration of infringement, impacted revenue, validity and clean title) that buyers may want to consider. Savvy patent buyers know that this saves them from performing much of the costly due-diligence to make their decisions to buy at certain prices. For instance, patent buyers typically spend around $50,000 for a $500,000 portfolio, around $100,000 for a $1 million portfolio and $250,000 and more for patent portfolios costing more than $5 million.

Conclusion

Bankruptcy professionals are increasingly turning to brokers that offer the complex business, technical and legal expertise required for conducting effective patent sales. To obtain the best price possible in a reasonable timeframe from the emerging patent marketplace, three factors must be considered by the patent owner:

1. *Patent Expertise*. Patents are complex assets, typically requiring expertise beyond the scope of most bankruptcy professionals tasked with recovering value from distressed companies.
2. *Market Dynamics*. Price is directly dependent on understanding why companies buy patents.
3. *Process*. The patent sale process must provide to all potentially interested buyers the complete and accurate but concise information needed to fully assess the patent's value, and an environment that enables the buyers to bid in a fair and manageable way.

The bottom line is that owners and creditors holding distressed patent assets now have a viable path to liquidity to consider before or during the bankruptcy process. In cooperation with insolvency professionals, patent transaction experts provide specialized services to assist in unlocking the value in the patents. ■