

# Business Valuation Notes

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Are your Patents Defensible...

## INTELLECTUAL PROPERTY VALIDITY

...Without Validity, there is no value

Many patents issued may be unenforceable. If true, the probability of an individual patent holder defending a patent is low.

In an article entitled "Realize the value of patent quality", author Cheryl Milone contends that for most companies, when patent filings are conducted, the validity research during filings is not complete enough; the filer uses minimal prior art searches, which is not sufficient.

**Patent validity, according to Milone, is not adequately considered in valuation.**

Milone is founder and Chief Executive Officer of Article One Partners, a Peer to Patent® prior art search service. The September 2010 issue in Milone's article contained in *Managing Intellectual Property* (Issue 202, [www.ManagingIP.com](http://www.ManagingIP.com)) renews concerns about patent quality and, therefore, appraisal conclusions.

Public and private business managers and owners should identify, understand, and prop-

erly protect these important assets.

The ambiguity of patent quality extends to patent value because when analysts value patents the valuator normally assumes the patent is valid. If the patent is not valid, the property does not have protected rights and, in fact, the holder may emerge with large liabilities due to infringing on another patent holder.

**There is no prescribed process to rank and quantify the probability of litigation success.**

Minnesota Business Valuation Group President Randall Schostag agrees the enforceability of intellectual property validity is something which appraisers are ill-suited to judge without tools which supplement conventional valuation procedures.



Schostag

Schostag believes in many cases appraisers should obtain professional oversight from those engaged in filing, maintaining, and defending intellectual property

## CHANGES PROPOSED FOR EXPERT REPORT DRAFT DISCLOSURE

*Business Valuation Resources*, <http://bvwirenews.com>, has alerted business appraisers that the US Supreme Court has ratified changes to Federal Rules of Civil Procedure. Experts' draft reports will no longer be discoverable in most instances at trial.

Laurel Sorensen, Senior Business Appraiser, Minnesota Business Valuation Group, said the rule change is significant. Appraisal is iterative and may require several draft reports before a valuation report is complete.



Sorensen

"Keeping all drafts and having them used as if the drafts mean that our opinion changed for anything other than a refinement of our work process is simply wrong," Sorensen said. "Doing a valuation is a series of steps consisting of approaches, methods, and procedures which assist an analyst in reexamining conclusions.

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# IP

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rights. MBVG works in close alliance with patent attorneys at Schwegman, Lundberg & Woessner, a Minneapolis, Minnesota headquartered intellectual property firm.

Milone, in the article, writes, “For a patent to be considered at its highest value, it must first have high quality.” Although cases may be brought for infringement or other reasons, according to Milone, ‘knockout prior art’ will trump other arguments.

**The best proof of validity is if a patent is litigated and is adjudicated to be solid, Milone writes.**

Business Valuation Resources, LLC, issued a copyrighted practice guide *BVR’s Guide to Intellectual Property Valuation, 2009 Edition* wherein author Michael Pellegrino observes the limited legal skills of most appraisers; he notes that valuation analysts must understand the implications on value driven by the legal nature of intellectual property. (See 6-2, for example.)

There are several critical factors when valuing patents, Schostag said. (See “Circuit Court Opinion, Increased Patent Value”, *Business Valuation Notes, Volume 10, Issue 7, July 2010.*) “Among important considerations are market size and growth, competition, internal product synergies, duration of remaining protection period,

complementary assets and management capability, and other considerations,” Schostag explained.

“But none of those are important if the patent has no value or the holder is infringing on someone else’s idea.”

Using litigation as the ultimate arbiter, however, is not satisfactory. Mark Lemley and Carl Shapiro in the *Journal of Economic Perspectives (Volume 19, Number 2 – Spring 2005 – pages 75-98, “Probabilistic Patents”)* say only 1.5% of patents are ever litigated and only 1.0% of patents are ever litigated to trial.

At the time of the article, the authors estimated “Roughly half of all litigated patents are found to be invalid, including some of great commercial significance.”

(In *FTC/DOJ Hearings on Competition and Intellectual Property Law in the Knowledge-Based Economy, Statement of Cecil D. Quillen, Jr.*, March 19, 2002, the presenter, former General Counsel of Eastman Kodak and Senior Advisor at Cornerstone Research, said before the Federal Circuit 2/3 of litigated patents were ruled invalid while after the Federal Circuit about 2/3 of litigated patents were ruled valid.)

In the American Intellectual Property Law Association *AIPLA Quarterly Journal*, (Volume 34, Number 1, Winter 2006, page 3) authors Paul Janicke and LiLan Ren wrote:

“For a number of years, accused patent infringers have been

winning patent infringement suits at a rate of three to one. While patent owners win slightly more than half the cases that proceed to trial, they are losing more cases overall because most end in summary judgments of noninfringement.”

The *AIPLA* study was conducted using 262 cases over a three-year period from 2002 through 2004.

“We found, first of all, that about 25% of the 262 dispositive cases were won by the patent owner (according to our definition of winning) and the other 75% by the accused infringer,” according to the authors. The article qualifies, however, that the patentee must prevail both as to validity and to infringement to be counted a winner; still a smaller than dominating majority should be expected.

Schostag said that patent reforms which have followed since that study have been aimed at reducing failed outcomes, easing the process, and enhancing the quality (validity) of patents issued. There’s more pressure on the USPTO to uncover conflicting prior art.

“The fact remains, however, that prior art research is still often inadequate and the intellectual property appraiser may rely on a faulty assumption of validity,” Schostag said.

“MBVG believes that patents enable an owner to assert certain rights, but patents are not a guarantee of the rights. Therefore, MBVG thinks a pat-

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ent is like an option which expires if it's found invalid. Enforceability follows a path from near total uncertainty to near certainty with respect to defensibility.

**“This path is marked with benchmarks and milestones,” Schostag said.**

In *Business Valuation Notes*, “Analysis with Patent Landscape Mapping”, Volume 10, Issue 4, April 2010, landscaping methods to evaluate if it's worthwhile to develop intellectual property was discussed from a Freedom to Operate (FTO) perspective.



**Lundberg**

Because landscape mapping (better termed Covered Matrix Analyses) includes a survey of existing and potentially competitive technology, this tool is also useful for ascertaining the strength of a patent, according to Steve Lundberg, SLW Chief Executive.

In a “Valuation Tutorial for CAV Software Program”, *Valuation of Early-Stage Technologies*, presentation by Ted Hagelin, Professor of Law, Director, NYS Science & Technology Law Center, Syracuse University College of Law, Hagelin cites five stages of development (and pricing) by many venture capitalists for valuing intellectual property using the “back of the envelope”:

Well Protected technology, Working prototype, Great market

potential and well written business plan, Beta tested technology, and Actual Customers with product sales.

This informal rule-of-thumb approach allocates 20% or \$1 million to each of these attributes for a total of \$5 million. He acknowledges, however, that such a calculation fails to appreciate the research necessary for a valid patent.

“We joke about a ‘Rule of Thumb’ to be only good for valuing thumbs,” Schostag remarked. “If the first step in the ‘back of the envelope’ formula is weighed in error, the rest of work means little.”

In a paper dated November 6, 2006, Alan Marco, Department of Economics, Vassar College, Poughkeepsie, NY wrote in a Vassar College Economics Working Paper (#68) examined the impact on publicly traded companies which are challenged in court litigation about intellectual property infringements.

Marco believes using publicly traded companies offers a way to evaluate the effect of measuring the value of uncertainty prior to litigation.

In the paper *Learning by Suing: Structural Estimates of Court Errors in Patent Litigation*, November 7, 2006, Marco concludes a patent value can be disaggregated to estimate for patent validity. Marco concludes resolving the uncertainty is worth 10%-15% of the average innovation value or 20%+ from discounted value.

“A significant variance in an outcome from one approach alerts the appraiser to reexamine other approaches for potential error.”

Civil actions follow certain rules for conducting a civil case. These are called the Rules of Civil Procedure. Federal rules of civil procedures must be followed if the case is filed in federal court. States have their own set of rules of civil procedure, although they're generally patterned after federal procedures.

The Federal Rules of Civil Procedure that govern all aspects of trial in the U.S. District Courts include: commencing an action; issuing and serving a summons and complaint (also called "service of process"); filing an answer, motion papers and other documents with the court; and court orders.

The applicable rule is Rule 26, especially relating to the duty to disclose or general provisions governing discovery for civil lawsuits. This rule is based on the principle that everything needs to be brought to the table at the beginning of a case so that no parties are surprised with evidence or testimony.

Changes to the FRCP are made through advisory committees. The change to Rule 26, proposed for Congressional adoption, has been approved by the Supreme Court so that drafts of expert reports would be exempt from discovery by opposing parties, except in certain cases, as well as some communications with attorneys.

## Professional Business Appraisals

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR INTANGIBLE ASSETS OR INTELLECTUAL PROPERTY, ESOPs,**

**MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION, GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

**OUR FORMAT IS POWER POINT - BASED.**

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY INSTRUMENT.**

**WE WILL CONNECT OUR COMPUTER.**