



# Patent License Evaluation

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One of the most effective methods for gaining additional value from patents, trade secrets and their associated technology is a comprehensive, well-planned and successfully implemented licensing program. In this article, we will explore what it means to have a successful licensing program, how that success is typically measured, and the means for improving your program based on the interpretation of those measurements.

Along the way, we will also explore the difference between valuation and evaluation, the various techniques for establishing a productive yet realistic negotiating stance in regard to price and compensation factors, and potential objectives beyond revenue generation that may be accomplished by your licensing program.

## VALUATION VS. EVALUATION

When discussing licensing or intellectual property, one often hears the terms “valuation” and “evaluation” used. Many times it appears as though these terms are interchangeable, and indeed they may be depending upon how the speaker is using the term.

The terms are somewhat related in a certain sense, but by no means identical. Generally speaking, evaluation in the world of licensing is defined as the process of measuring certain attributes of a license or potential license against specific benchmarks, targets or rules of thumb. Many different examples of these attributes and the metrics associated with them are discussed below. On the other hand, valuation is defined as the calculation of the value of a specific asset, be it a patent, trademark or license.

Value can certainly be considered one of the targets under which a license is to be evaluated, and may indeed be one of the most important, but it is not the only metric that is used. A valuation of patents, trade secrets and technology usually calculates fair market value (“FMV”), which is defined as the price at which an asset would exchange between a willing buyer and a willing seller, with each having reasonable knowledge of all relevant facts, and neither being under any compulsion to act. This is the standard that was identified by the Internal Revenue Service in its Revenue Ruling 59-60 and is most often utilized when calculating an intangible asset’s value. It is not always appropriate to use the FMV standard, however. Certain aspects may need to be changed so that the analysis more closely replicates a specific situation.

For example, a bankruptcy may compel a seller to dispose of certain properties. This compulsion to act would negate the “willing seller” aspect of the FMV definition. Also, since the FMV standard is considered to encompass a typical buyer or seller, the consideration of attributes associated with a specific buyer or seller, one that may have a higher level of

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resources than a typical buyer or seller or be an industry leader, would likely require a different standard of value.

## PRICING TECHNIQUES

After this brief discussion regarding valuation standards, it may seem relatively easy to determine an appropriate price for licensing a patent. In the real world, however, the price for licensing a patent is the product of a negotiation, one that may in many cases be a lengthy process. What this means is what the FMV standard alludes to: the license will generate only as much revenue as a third party is willing to pay for it.

When licensing patents, there are many different aspects that need to be considered and negotiated by each of the parties, including the assets to be licensed, the products involved, timeframes, geographies, exclusivity, sub-licensing ability, guarantees, and compensation. The compensation for the use of the asset can take many different forms. There can be an in-kind barter for use of assets owned by the other party.

Referred to as cross licensing, this form of compensation applies in situations where two parties have different pieces of core technology that are both needed to manufacture a competitive product. In other licenses the compensation may be paid in full. A fully paid license is frequently used to access customer lists and in other instances where tracking usage is difficult. Another compensation method is one in which a specified amount is paid for each unit sold.

One of the most widely utilized compensation methods in licensing is a percentage of the revenue associated with sales of products featuring the patents being licensed. The percentage payment is referred to as a royalty payment. When using this method, it is very common for the licensor to insist upon a guaranteed minimum royalty payment. In this way, the owner of the property being licensed is assured that the licensee has an incentive to sell as much as it can.

Other issues that will likely be negotiated include a duty of the licensee to protect the asset against unauthorized use, to not do anything that will damage the validity of the licensor's ownership of the asset, and to assign to the licensor any additional rights associated with the asset that may be acquired during the life of the license. Additional aspects of control that are typically required by a licensor include maintaining adequate insurance, overseeing quality control and ensuring compliance to government, industry or asset usage standards. It is important to understand that because of the give and take nature of negotiation, particularly stringent requirements in one area may call for leniency in another.

So how does one establish a negotiating position, especially in regard to price? There are a number of techniques available that will enable a licensor to negotiate reasonable compensation based on a realistic assessment of attributes specific to the patent, trade secret or technology being licensed and the context in which the potential license is being negotiated. One that is routinely used is the market comparable method. With this technique, the potential license is compared to other licenses that have been granted recently for similar technology in the same industry and under similar circumstances. It is very much like the pricing activity that accompanies the listing of a house for sale.

Typically, the asking price for a three bedroom house on a cul-de-sac within walking distance to good schools is set by reviewing recent prices for similarly situated homes. It is sometimes difficult to find an exact comparable so certain ratios are often used to standardize the information to some extent. With a house, this usually takes the form of price per square foot. Using this ratio, a three bedroom home with 2000 square feet of space that sold recently for \$400,000 would have a ratio of \$200 per square foot. A similarly situated home with 1900 square feet would command a price of \$380,000 according to this ratio. Appraisers also have techniques to take into account the lack or presence of a high traffic street or other important variable.

These same types of adjustments are oftentimes necessary when comparing technology licenses. For example, a similar technology licensed in the same industry and under the same circumstances may still be useful even though the comparable license was granted ten years before. Analyzing changes in royalty rates or other compensation forms that have taken place in the interim will provide the level of adjustment necessary to make the information contained in the older license an accurate guideline for the potential license.

Comparable transactions can be difficult to track down in many cases, but there are sources available. These may include databases maintained by private organizations, the contents of which are usually available for sale, and survey data from relevant organizations. The best comparable, of course, is a previous license for the same technology.

Many times a close comparable is not available, or the number or quality of close comparables is not particularly compelling. In these instances, it is customary to analyze the profits that are likely to be generated by the sale of products featuring the licensed technology and determine the impact of the various complementary assets necessary to manufacture, package, market and distribute the products.

Broadly speaking, this kind of compensation analysis is referred to as the 25 Percent Rule. This rule is based on the fact that a licensee will be unwilling to pay an amount that is inconsistent with the realities of the market in which it operates. For example, a licensee is not going to agree to a royalty rate that is 10% of its net sales when its profit margin is only 10%. There is no incentive to compete in the marketplace when all of the rewards are going somewhere else.

Although it is known as the 25 Percent Rule, in practice the percentage may vary from 10% to 50% based on the extent and quality of the complementary factors that emphasize or minimize the contribution of the intellectual property to the enterprise as a whole. In general, patents that require many complementary assets in order to commercialize a product will generally obtain a lower portion of the operating profit than assets that require fewer complementary assets.

This method calculates the compensation for the use of the assets as a certain percentage of the operating profits of the enterprise in which the licensed intellectual property is used.<sup>1</sup> It is a simple rule of thumb that is based on equitably dividing the economic profits between the licensor and licensee according to their perceived relative contributions. It gives an

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<sup>1</sup> "Use of the 25 Per Cent Rule In Valuing IP" by Robert Goldscheider, John Jarosz and Carla Mulhern, Les Nouvelles, December 2002

approximate estimate of the price that would be paid in a reasonable arm's length negotiation.

Aspects of this rule of thumb that have made it popular include:

- It considers the respective contributions of the seller and the buyer, and apportions the anticipated benefits accordingly.
- It is based directly on resulting benefits. The 25 Percent Rule is focused on the operating profits of the firm using the assets, which is widely considered to be an appropriate measure of the benefits associated with the successful use of intellectual property.
- More to the point, it is frequently used to form the basis of negotiations. If parties entering negotiations agree beforehand that the split of expected profits will be based on applying the 25 Percent Rule in a mutually agreeable way, it can be helpful in defining expectations at an early stage.<sup>2</sup>

The concept advanced by the 25 Percent Rule is widely recognized in the licensing community. It appears in most articles concerned with royalty rate determination and has been cited as a valid methodology in several court cases.

The proper application of this analytical technique requires identifying the operating margins associated with the sale of goods or services that utilize the technology and then apportioning them to the licensee and licensor in accordance with their respective contributions. When the operating margin for a potential business is unknown, a suitable approximation is typically used. Many times these kinds of assumptions are the subject of as much negotiation as any other aspect of the license.

## LICENSING OBJECTIVES

Not every licensing program is going to add billions of dollars to the bottom line like those associated with IBM or Canon. In fact, many times the additional revenue generated by the license is in addition to other goals. Some other objectives associated with a potential license may include the following:

- Protect the patents from invalidation claims. This objective is used when there are many similar technologies in a very competitive field. Being able to show that a competitor or other player in the industry is willing to license the technology indicates that the claims are valid.
- Strengthen one's position in a counter-suit. Similar to the discussion above, if the technology is already the subject of litigation, a willing licensor may provide evidence of valid claims.
- Increase leverage for additional financing. An effective licensing program shows the ability of the technology to generate revenue in the marketplace and also indicates that the technology is well regarded in the industry.
- Generate or facilitate cross licensing. This is another potential goal, as this activity typically provides a company with greater freedom of action in the marketplace and may shorten the time needed to bring a product to market.

<sup>2</sup> "Intellectual Property Valuation" by David Drews, Drafting License Agreements, Fourth Edition, page 23-17.

- Recruit potential partners, employees and students. For example, many universities become known for expertise in a specific field through research and development that leads to successful licensing programs, which increases the likelihood that they can recruit both students and professors that have an interest in that area.
- Increase the speed of expansion or growth of your company. Licensing allows one organization to utilize expertise and resources from another organization in the pursuit of additional market share.
- Enter into markets or industries that are outside your core competency. Similar to the objective above, geographic or industry expertise allows penetration into markets that may have been passed over otherwise.
- Finally, licensing your patent to others in the same or related industries may help your technology become the standard, which provides a form of protection unavailable through any other means.

## EVALUATING LICENSING SUCCESS

Determining whether a license is successful or not is very much dependent upon what objectives one has for the license and what the expectations are. The main problems associated with successful licensing and license evaluation are inadequate preparation and poor execution.<sup>3</sup> Of course, the antidote to these problems is to understand what it is you want to measure and how to measure it.

If revenue generation is one of the key objectives associated with a licensing program, the metric used to evaluate that objective needs to be tied to the revenue expectations associated with the license initially. Let's assume that a license was expected to generate \$1 million of revenue in its first year. After the year is up, the license has only generated half that amount. After determining that the objective was not met, the next step in the evaluation process is to determine the cause of the shortfall.

It may be that the marketing campaign lacked energy or that the distribution network was beset with problems. While real problems that need to be addressed, they do not necessarily point to a problem with either the technology or the setting of the goals. On the other hand, it could be that the strength of the technology (measured as demand for the products featuring the technology) was not as robust as initially anticipated. In this case, additional investment in the technology may be required. It may also be that the market potential for the technology was overestimated and that the goals for the license need to be revisited.

The other objectives are typically handled in a similar fashion, although it may be more difficult to calculate an exact impact for some of them. These more difficult measurements may include recruitment of employees, setting standards, obtaining additional financing and discouraging invalidation claims.

An important tool for licensing evaluation is benchmarking. This is the most effective method for determining if the expectations for a license or licensing program are realistic

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<sup>3</sup> "A Primer on Benchmarking a Licensing Operation" by Patrick H. Sullivan and Henry E. Fradkin, *les Nouvelles*, September 2001.

and if the license is meeting those expectations. The key to using this technique effectively is to select the proper benchmarks. These can either be comparable products or licenses in the same industry or can be set against the best-in-class practitioners for many different industries. It is important to align the benchmarking with an activity that shares similar objectives for the license. The best-in-class comparisons will likely have to be adjusted using similar techniques to those described for the market comparable method discussed above and are probably less useful for a direct comparison of actual results.

Where these best-in-class comparisons are useful is for ascertaining where your licensing program may have structural problems. Benchmarking can provide answers as to how the most successful licensing operations are run. They therefore are used to improve practices that lead to a more successful licensing operation, whether your objective is to generate more revenue, become the standard in your industry or simply gain a presence in a new geographic market.

## CONCLUSION

Licensing your technology can allow you to achieve a wide variety of corporate goals, including revenue generation, faster product launch timetables and return on investment objectives. The key to a successful licensing program is to define your objectives and determine the appropriate implementation processes to meet those needs.

An important part of this is to have a realistic negotiating stance that is based on real world market characteristics for the industry in which you are competing. Once the license is in place, effective and accurate tools for measuring the results against the initial goals are imperative for determining the success of the program. Finally, success has different meanings for different organizations. The most successful will have a clear understanding of their goals and how to accomplish them.

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