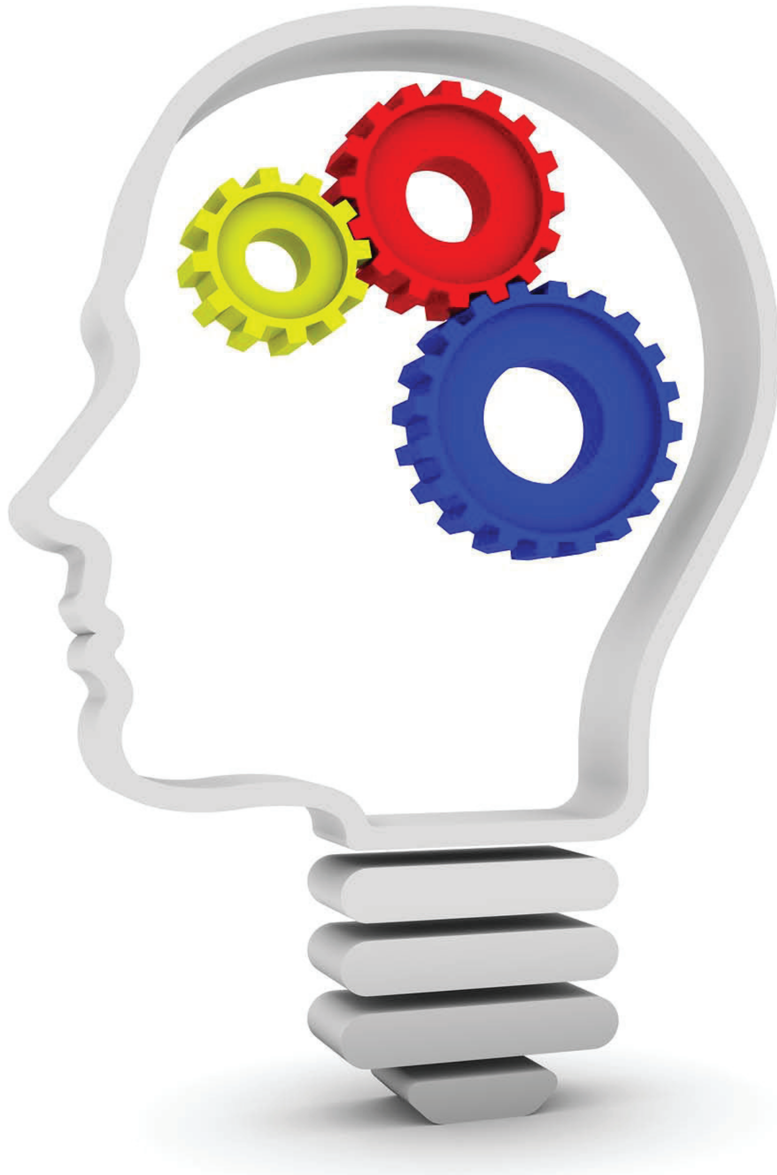
Business Law POV

Determining the Value of a Patent or Patent Application

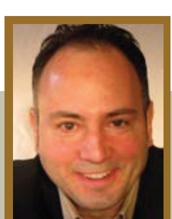


By David L. Hoffman

MOST LAWYERS KNOW THAT THE VALUE OF A business is made up of the value of its assets. Tangible assets like stocks, bonds and real estate have relatively straightforward methods of valuation. By contrast, intangible assets such as patents are much harder to value.

Determining patent value is vital for many purposes. The method by which value is determined can also vary greatly. For most purposes, there is no generally accepted methodology. Many times valuation is subjective. There are several reasons to value a patent:

- As an asset in the purchase or sale of the patent itself
- For determining damages in a litigation
- For determining the royalty rate and any upfront license fee in a licensing transaction
- As an asset or collateral for a loan or stock offering or similar transaction
- As an asset in the sale of the company
- In a potential transfer from one entity to another
- As an asset in a bankruptcy estate or company dissolution
- As an asset in the probate estate in the event of death of an owner



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Many of these reasons are occasioned by potential or actual legal proceedings or contracts. Like any asset, knowing a patent's value can be critical to a client for making good strategic decisions. "Business owners should be proactive about assessing and knowing the value and competitive advantages of their businesses' intellectual property, including patents," says business valuation expert Davis Blaine of The Mentor Group in Westlake Village.

Value can change over a patent's life, typically twenty years from its earliest filing date.[1] Initially, upon invention, a company must decide whether to even file a patent application. There are two important considerations at this stage. The first is the potential market for the invention. This is not the entire potential gross sales. Rather, the portion of gross sales attributable to a patent is often determined by subtracting out any other factors, including the company's innate ability to manufacture and deliver good products or services and market them. Once all other factors are removed, then the remaining expected profit attributable to any patent that might issue can be determined.

The second factor to consider is the potential scope of any patent that may be obtained. How much competition might a patent exclude, if any, and/or what price differential might it support versus the competition? Because patent issuance is a contingency, the likelihood of issuance should be factored into valuation.

Sometimes these factors are determined by a gut valuation. Ideally, they should be carefully considered, for example, by performing a patent search to gauge what, if anything, may be protectable.

From an accounting standpoint, a pending patent application's value might simply be the cost to prepare and file it. However, this cost approach is unlikely to reflect the competitive advantage that a patent may provide. If it is a ground-breaking invention in a huge market (e.g., the laser), the value is obviously not just cost. By contrast, even if it is a great invention, but there is no market, the application may be worthless. To be most effective, counsel for the company should encourage the client to fully consider these factors.

In any event, it is important for the company to determine the value in order to figure out how much to invest in commercializing the product or service and in protecting it.

Following the invention phase, the company needs to decide whether to try to sell or license the application and/or sometimes to borrow against it. A patent application may help attract investors. In this case, the application's value may depend on the amount of investment and may be all of the investment or just a portion. If one licenses the patent, then the royalty income may be used to measure value. If one can borrow against it, the value to the company of the loan (which is not necessarily the loan amount) could be used as the value.

Once the patent issues, any of the above methods can still be used to determine value as appropriate. While issued patents carry a presumption of validity,[2] there still could be a discount for any potential for invalidation.

One of the reasons for valuation, as an asset in the sale of the company, is common. It is particularly important to have a valuation in this situation to help speed up an otherwise slow process of sale and to streamline negotiations. According to Mr. Blaine, chairman of The Mentor Group, Inc. and Mentor Securities, LLC, "sellers should be well prepared [including] understanding what intellectual property is owned by the company and the advantages it provides." The result is often reflected in an increased price for the business, according to Blaine.

Where there is a product or service for sale, the value of the patent is best determined by an income approach—what is the cash flow from the patented product or service, and how much of that cash flow is attributable to the patent? The cash flow might increase when the patented product or service helps sell other products or services of the company (convoyed sales).

If there are no products or services for sale, or for a number of other reasons, the patent may be valued by a market approach—what would a willing buyer pay for the patent? This is a hypothetical approach where past sales of similar patents may be used as a gauge. In this case, determining value might be analogized to how an appraiser values real estate using comps.

Sometimes a patent's value can be damaged over time, for example if a company fails to enforce the patent or if previously unknown prior art (past similar patents or publications) or other facts arise that cast doubt on the patent's validity.

Many patent owners do not know or improperly estimate their patent portfolio's value. Patents typically account for less than 20% of the value of a business, even in the case of technology companies. As noted by valuation professional Daren Mesrobian of Vineyard Capital Advisors, Inc. in Pasadena, "a patent, while having some value independently of the company, is much more valuable when it is able to leverage a business' name and customers."

Understanding and keeping track of the value is important to the business owner and practitioner in many circumstances, whether deciding to file a new patent application, pricing a patent for sale or license, or selling a company.

[1] *See* 35 U.S.C. §154.
[2] 35 U.S.C. §282.