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Patent Encumbrances Can Reduce Market Value up to 100 Percent

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Patents can help business startups in a number of important ways. Filing a patent application can aid a startup's first mover advantage as a patent grant gives them the right to exclude others from a market sector, which could prove to be very valuable for a variety of reasons — not the least of which is to attract investors keen to invest in companies with some strategic advantage in the marketplace.

Patents can also help minimize the risk of facing an infringement suit because it gives a startup an asset to assert defensively if and when an aggressive competitor might come knocking. But even if a defensive position does not ultimately prevent litigation from initiating having patents can open the possibility for counterclaims and cross-licensing settlements, which sometimes are the primary strategic reason patent lawsuits are filed in the first place.

These are well known examples of the advantages of patents to start ups and the venture capital firms (VCs) that often fund them. However, patents also help startups and the VCs that development and commerce. If a startup fails, which ends up happening to the overwhelming number of startups, the sale of the patents can give investors a chance to recoup some of their funds.

The sale of a patent becomes more complicated and less valuable if the patent rights have been compromised. Not surprisingly, an encumbrance upon a patent negatively impacts the market value of the patent because it reduces the ability of others to monetize that patent by removing at least some avenues of opportunity.

Encumbrances can take several of different forms. A patent licensing agreement is an encumbrance because it prevents a company buying a patent asset from obtaining royalties from a company that has already licensed the patent. Companies can also sign covenants not to sue each other that can run with the patents. If those patents are sold while those covenants are still in force, the patent's market value is similarly limited.

Patent broker Brad Close notes that encumbrances can have the effect of reducing a patent's value by up to 100 percent, practically rendering a patent valueless on the market. "If the only companies which are potential targets for a license are already licensed, then the intellectual property is essentially worthless," Close said. Close has worked as a patent broker for 12 years and has spent parts of the last decade working on brokering patent sales for startups while working with such firms as TIPS Group, Transpacific IP and Blackstone IP.

"If a startup is considering entering into an agreement that would place an encumbrance upon a patent, I would advise them to be very sure that what they're receiving in return offers adequate value and to take into consideration both their investors and the future of the business," Close said.

Certain organizations and consortiums in the patent sector require their members to enter of avoiding litigation from PAEs and NPEs may seem attractive to startups, Close notes that startups don't face the same litigation risks of much larger entities. "True NPEs don't target startups because they don't have the market share to make litigation worthwhile," Close said. "NPEs are typically going to go after companies who hold a significant share of the market."

LOT Network poses the question of whether membership in the consortium is appropriate for a startup as a simple one: If the firm is optimistic about its future and expects to remain in business, then it should consider joining to mitigate its litigation risk. "[I]t comes down to whether you're optimistic about your future," Ken Seddon, the CEO and president of LOT Network, told IPWatchdog in an interview in August 2018.

Close doesn't believe the question is quite as simple as Seddon makes it out to be, because a market exit might not be the only scenario under which a startup may want to sell patent assets. "A startup might create IP to protect, say, a widget product, but if the startup decides to go in a totally different direction, it might behoove the company to sell their widget-related IP if they become cash-strapped," Close said. "To just say, 'Hey, don't you believe in your company?' ignores the reality of the situation and substitutes pride for logic."

Close noted that 90 percent of the patents he has brokered from startups have gone to patent aggregators and NPEs. A startup joining a consortium such as LOT Network would essentially foreclose those opportunities. "It really takes us back to the fact that encumbrances aren't good for investors or rapidly changing startups," Close said. "The benefit of not being sued by an NPE is really small for these startups. I don't think that the claimed benefit they're getting may be worth the price of trading value on their patents."

Image Source: Deposit Photos.

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" … Can Reduce Market Value up to 100 Percent" is a peculiar construction. Instead, one might say " … can reduce market value to zero".

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