

The US\$4.5 billion tipping point

It was the largest patent auction in history and triggered a summer of sales featuring some of the world's biggest technology players. But will the Nortel patent auction prove to be a game changer in the way that intellectual property is viewed and valued?

By Helen Sloan

When historians of the future come to tell the tale of Nortel, there is a good chance that the epilogue will be just as fascinating as the company's life story. The Canadian telecoms operator was one of the stars of the dotcom boom, but crashed to earth spectacularly when the bubble burst, its stock price plummeting from C\$124 to C\$0.47. The company never really recovered, filing for bankruptcy protection early in 2009. But it is Nortel's posthumous legacy that was behind one of the most extraordinary events of 2011, in the IP world and far beyond.

Background to the sale

In June 2009, after a few fruitless months trying to salvage the company, Nortel announced that everything that remained of the defunct enterprise was for sale. Most assets were sold off in a piecemeal fashion: Ericsson, for example, acquired the Multi Service Switch operation, while Avaya picked up the Enterprise Solutions business (along with 6,000 former Nortel employees).

Nortel's portfolio of patents was the last and most valuable slice of the inheritance to be put up for sale. It consisted of around 6,000 patents and patent applications covering a wide range of technologies,

including wireless, data networking and semiconductors. Crucially, though, the portfolio also contained long-term evolution (LTE) patents relating to 4G mobile phone technology – assets that any major player in the smartphone sphere would do well to have as part of its IP arsenal.

Before the auction

An in-depth evaluation of the portfolio was the first stage of the sales process. Playing a vital part in this pre-auction period was the Global IP Law Group, which served as Nortel's IP counsel. Steven Steger, founder and managing partner of Global IP, explains how in the autumn of 2009 his firm began an in-depth analysis of Nortel's patent stash, recognising early on that it was a high-quality collection. "One of the misconceptions when we first started was that it was a heavily encumbered portfolio," he explains. "Going through the portfolio, we realised that it had clear application to every aspect of telecoms, both wired and wireless, handset side and base station side."

An auction was not inevitable at this stage, and with other Nortel advisers Global IP continued to explore all options, including a licensing programme. Then, towards the end of 2010, the firm brought the portfolio to market. Along with Nortel's financial advisers Lazard, they visited interested parties' internal IP teams to explain the value of owning the patents.

David Berten, another founding partner at Global IP, describes how they ensured that potential purchasers understood the depth and breadth of the collection. "We certainly spent a lot of time analysing the portfolio," he says, "working with the internal Nortel team to understand it, to be able to demonstrate quickly how the patents applied to a whole bunch of different



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Global IP Law Group

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The auction round by round

The Nortel patent auction began on 27th June and ended four days later. It was held in the New York offices of law firm Cleary Gottlieb Steen & Hamilton. The initial bidders were Apple, Intel, Ranger (Google), Norpax (RPX) and Rockstar Bidco (Microsoft, EMC, Sony Ericsson and Research In Motion consortium).

This is how the bidding went:

- Intel selected as opening bidder.
- **Round 1** - All others place new bids. Increments increased from US\$5 million to US\$50 million.
- **Round 2** - Norpax does not bid. Increments increased to US\$100 million.
- **Round 5** - Rockstar does not bid. Apple partners with Rockstar.
- **Round 6** - Intel does not bid.
- **Round 8** - Intel partners with Ranger.
- **Round 9 to Round 18** - Rockstar v Ranger bid in turn.
- **Round 19** - Rockstar bids US\$4.5 billion.
- **Round 20** - Ranger withdraws.

technology areas. We didn't focus on a single market; we tried to demonstrate that the portfolio had applicability to different markets. A lot of people think of it as a handset portfolio, but it wasn't – it deals with handsets, with wireless infrastructure, with wired activity, with optical systems. There was a whole host of technologies.”

At the end of this process, non-binding submissions of interest were filed and it became clear that a sale of the whole portfolio was the best monetisation option. Detailed discussions with the handful of serious buyers then led to a stalking horse bid that was, to the outside world at least, the first sign that a very interesting auction was on the cards.

The stalking horse

Google was selected as the stalking horse, with a hefty binding bid of US\$900 million. John Amster – CEO of defensive patent aggregator RPX Corporation, another party interested in purchasing the portfolio – saw it as a “very high figure”. It was one, he says, “that was a very large premium over what any other buyer was willing to pay at the time”. This reflected Google's vulnerable position in the smartphone market. While the other bidders may have wanted the patents, it was only Google that really needed them. Google's Android smartphone platform is “on fire”, according to Google's own estimation, and it is hard to argue with

the statistics. Globally, Android is the biggest player; its US market share had been shooting up, while Apple's remained static. But behind this success story was a major chink in Google's armour: its own patent portfolio was tiny, leaving the company with little leverage in the ongoing smartphone litigation wars. Acquiring the Nortel portfolio would have left Google in a considerably stronger position.

Google perhaps hoped that making such a high stalking horse bid would frighten off the competition, a theory with which Amster agrees. “I think that was their goal: they were going to shock and awe people away from participating in the auction,” he says. But if this was the plan, it backfired. For a start, RPX was not dissuaded. “Quite the contrary,” Amster says. “I think that signal created strategic imperatives in the minds of many of these companies that didn't exist before that bid came down.”

With Google's hat now in the ring, four other bidders emerged: Apple, Norpax LLC (an offshoot of RPX), Intel and Rockstar Bidco, a consortium of Microsoft, EMC, Sony Ericsson and Research In Motion. Each bidder had slightly different reasons for wanting the patents. For RPX, Amster explains, they were attractive because they had the potential to protect clients from non-practising entity (NPE) actions further down the line: “We saw this portfolio – as did many of our clients – as one that, in the wrong hands, could be the source of many, many lawsuits. The main goal for us was to keep the portfolio as one and to keep it out of the hands of an NPE. And from that perspective, we reached our goal.” Other bidders no doubt had different motives, and with so many high-profile players on board, the auction became one of the most highly anticipated events of the year.

The auction

The auction took place at the end of June. Participants are unwilling to give details of what happened behind closed doors during those four days; however, the facts of the process are publicly available (see box on page above for a summary). RPX was the first to withdraw and John Amster explains why: “The main thing was it was becoming clear that it was going to be driven by the strategic objectives of very large companies, and that it wasn't our place to be trying to be the winner at that level.” The final result then came down to a battle between two consortia, both of which were formed during the auction process: Ranger, consisting of Google and Intel; and Rockstar Bidco, which had added Apple to its original

Nortel – the antitrust angle

The Department of Justice is currently investigating possible anti-competitive elements with the Nortel deal. Robert Skitol (right), an antitrust specialist and partner of Drinker Biddle in Washington DC and a member of the board of the American Antitrust Institute, explains some of the issues:

What was involved in the Nortel auction and result was not a matter of individual buyers competing against one another to acquire a patent portfolio; it was a consortium of purchasers that included three main horizontal competitors. Apple, Microsoft and Research In Motion are the leading competitors against Google in the market for mobile operating systems, and they were acting not individually in purchasing an available patent portfolio, but collectively, with no indication of what would follow their collective acquisition.

They ended up bidding and paying four times what Google offered, which raises the question as to what their ultimate objective would be and what would be the ultimate enforcement of the patents. We don't know whether or in what manner those horizontal competitors are going to act together to cripple Google in the mobile operating system base.

At the time that the Department of Justice cleared the consortium [before the auction], it included Microsoft and Research In Motion, but



did not include Apple. Apple was a separate competing bidder and Apple is the leading force in the affected market. So that was a major change from the time of the clearance.

The investigation could take several months to come to a conclusion; I would not expect a quick result. I would expect that the Department of Justice will do a very thorough investigation and file subpoenas for large amounts of documents from each member of the consortium, and ultimately there is the potential for a negotiated settlement in the form of a consent decree of some sort. That presumably would entail some commitment

about the ultimate use and enforcement of the various patents in the portfolio.

A precedent of sorts, or some indication of what it might be, is what the Department of Justice brought about on the Novell patent portfolio transaction this past spring. It was not a formal consent decree, but it did require that the acquired patents be divided up among the parties (Microsoft, Oracle, Apple and EMC) rather than be held and enforced collectively on a concerted basis. It precluded Microsoft, for example, from acquiring particular patents concerning particular technologies where Microsoft was already very strong. So it looks like a very thoughtful and good negotiated outcome, and that could be an indication of the direction that the Department of Justice takes at the end of its investigation of the Nortel deal.

Google's purchase of Motorola is an interesting new development. I would imagine that the consortium members that are targets of the pending investigation will try to make hay out of this – they will say, "Well, this eliminates or at least mitigates the potential for anti-competitive outcome, because now Google will have weapons of its own to protect itself against a patent enforcement by the Nortel consortium." To my mind, while there may be some truth to that suggestion, it still does not justify this kind of concerted action among direct competitors against Google.

line-up. After 19 rounds of bidding Ranger dropped out, leaving the Rockstar members as the owners of the 6,000 Nortel patents, and collectively US\$4.5 billion poorer.

Immediate reaction

If eyebrows were raised at Google's initial US\$900,000 bid, then jaws dropped when news of the final price was revealed. A figure of over US\$1 billion was certainly looking achievable, but when the gavel came down at US\$4.5 billion it thrust the patent marketplace into a whole new realm. Ron Laurie, managing director of Inflexion Point Strategy, describes his reaction as "the same as everyone else that I've spoken to, and that is disbelief". The huge sum paid was vastly more than what was expected and made the Nortel sale the biggest in history.

Google was initially seen as the loser: it wanted the patents badly; it didn't get them. But even in the immediate aftermath, Google could console itself with the fact that it still had several billion unspent dollars to play with. There has also been

some conjecture that Google did not really want these patents, but was trying to force its competitors to spend as much as possible. The quirky amounts that the company bid (eg, US\$2,614,972,128 – known to mathematicians as the Meissel-Mertens constant) during the process added fuel to this fire – was it taking this seriously? This would have been an extraordinarily risky strategy, however, and remains nothing more than rumour.

Google's own reaction suggests that such speculation is unfounded. On 3rd August, senior vice president and chief legal officer David Drummond posted on Google's official blog and described the Nortel auction, along with a sale of Novell patents earlier in the year, as "a hostile, organised campaign against Android by Microsoft, Oracle, Apple and other companies, waged through bogus patents". He voiced particular concern at Microsoft and Apple "getting into bed together". Google, it seems, was deeply unhappy to have missed out on the Nortel



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CEO, RPX Corporation

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treasure chest.

Another group with strong objections was the American Antitrust Institute (AAI). On 6th July Albert Foer, the organisation’s president, wrote to the Department of Justice urging it to conduct an in-depth investigation. The AAI focus fell on the fact that the purchase price was five times that of the stalking horse bid. “How could shared ownership of the Nortel portfolio be worth so much more to the Rockstar group than sole ownership of it would be to Google?” the letter asked. It also expressed concern that three of the winning consortium – Apple, Microsoft and RIM – are direct competitors to Google in the mobile operating system marketplace. The Department of Justice is currently investigating the deal.

The true value of the patents?

The vast sum paid raises the question of what intellectual property is worth and how it should be valued. “My first reaction is that it absolutely proves that no one knows how to value patents,” Laurie says. He points out that prior to the stalking horse bid, the figure being discussed – including by those involved on the Nortel side – was US\$1 billion. “The owners of a portfolio always overvalue it. They were off by a factor of four and a half. So what does this show? It shows that no one really knows how to value IP – especially IP that has strategic value.”

This strategic factor explains why the Nortel portfolio can be worth so much to certain parties. As Amster says, the final sale price “is not reflecting the intrinsic value of the patents, but is reflecting the strategic value that the companies placed on it.” Art Monk, vice president of US patent brokerage at UBM TechInsights summarises the different ways that patents can be valued. “There is the litigation value of a patent; there is the negotiation value of a patent; and there is just the value of the patent in freedom to operate. It turns out that the negotiation value of the patents in the Nortel portfolio is very high,” he says. And while Google desperately needed more patents to strengthen its negotiating position, its competitors were equally keen to ensure that it didn’t get them.

Monk takes a wider view of the auction result. “If you have two large competitors pounding away in a certain market, beating against each other, those competitors will do many different things to impact the balance sheets of their adversaries,” he says. “It’s all above board and it’s all the way the game is played: things like one competitor

dragging the other into markets they know nothing about, but feel they have to compete in; or going into a market that the other is weak in.” From this point of view, the battle for the Nortel patents is all part of a wider strategy. Each company has the same objective – to become the dominant player in the marketplace – and will do whatever it takes to hobble the competition. With its thousands of patents, Apple didn’t really need the Nortel portfolio for itself, as Laurie points out: “This is a classic factual setting for a bidding war where it is not necessarily that you want them; you just don’t want the other guy to get them.”

With strategic imperatives driving the price far beyond market expectations, it’s easy to forget that the patent portfolio in itself was extremely valuable. Steven Steger remarks that the high price paid reflects the fantastic work that Nortel had done in the research and development field. His partner David Berten agrees: “This portfolio is the result of approximately US\$40 billion being spent on research and development or in acquisitions. So to go out and try to replicate the portfolio from scratch, people would be paying tens of billions of dollars and waiting 10 or 15 years.”

Yet until 30th June, US\$1 billion was the anticipated sale price from most quarters; though not quite everyone was stunned by the final figure. Raymond Zenkich, a partner with Red Chalk Group in Chicago, was one of very few commentators predicting a multiple-billion figure before the auction. “We looked at several aspects of the Nortel portfolio,” he says, “and after applying a set of assumptions around quality, essentiality to standards and pricing – based on our brokerage activity in this space – for both the LTE and non-LTE portions of the portfolio, we felt that it was certainly possible that the entire portfolio could go into the multibillion-dollar range – especially if the ultimate buyer felt confident it could extract the value over time.” He also points out that Google would additionally have taken in strategic concerns such as the need to support and protect its Android ecosystem, pushing its own valuation ever higher.

A unique event

Most commentators agree that the Nortel patent auction is an event unlikely to be repeated any time soon, as a patent collection of this size, depth and quality has never been sold as a standalone portfolio before. “That was a fairly unique set of circumstances,” Steger says. “A company that was no longer operating and that had a

Timeline: from stalking horses to Big Blue purchases

- 3rd April:** Google makes US\$900 million stalking horse bid for Nortel patent portfolio.
- 13th June:** Deadline for opening Nortel auction bids.
- 18th June:** Auction delayed by a week due to level of interest.
- 27th June:** Auction starts.
- 30th June:** Auction concludes with winning US\$4.5 billion bid.
- 12th July:** Google purchase of just over 1,000 patents from IBM registered at the US Patent and Trademark Office.
- 19th July:** InterDigital announces that it is considering a patent sale.
- 20th July:** Canadian government approves the Nortel sale.
- 21st July:** Investor Carl Icahn calls for Motorola to consider patent sale.
- 30th July:** US Department of Justice reportedly intensifies its antitrust investigation of the outcome of the Nortel auction.
- 1st Aug:** Eastman Kodak announces sale of just over 1,000 of its patents.
- 15th Aug:** Proposed Google acquisition of Motorola Mobility, to include 17,000 of the latter's patents as well as thousands more applications, announced.
- 6th Sep:** Investor Jaguar Financial calls for Research In Motion to consider patent sale.
- 15th Sep:** A further purchase of just over 1,000 IBM patents by Google becomes public.

portfolio of very high-quality patents with a large number of assets.”

The fact that Nortel is defunct is important: potential buyers did not need to worry that the seller would reinvest the money and continue to compete in the same area. It also meant that the auction took place as part of a bankruptcy procedure, which has its own set of rules, as David Berten explains. “The bankruptcy court has to be assured that the asset owner – the debtor – got the highest or best offer that was available,” he says. “In order to do that, you have to be very transparent with the court, with the way that the process was run. That meant that all the bidders, for example, knew who all the other bidders were. So while the process was closed to the outside world, it was open on the inside: all the bidders knew who else was bidding and at least who the lead bidder was for each round. And that structure is very hard to replicate outside of the bankruptcy court.”

Aftermath

There was not long to wait before the impact of the auction started to be felt. With dollar signs in their eyes, companies and investors alike suddenly started to reassess their own patent holdings. Within weeks, wireless technology company InterDigital announced that it was contemplating the sale of some or all of its intellectual property – interested parties reportedly include Google, Apple and Intel. By the end of July, the struggling Eastman Kodak also declared that it was selling 1,100 patents – around one-tenth of its portfolio.

The question of what Google would do next was also quickly answered. A relatively modest purchase of 1,000 patents from IBM in July (followed by another 1,000 a month later) turned out to be just a taster of the spending spree to come. In mid-August Google announced that it had purchased Motorola Mobility for US\$12.5 billion – a deal that came with over 20,000 approved



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and pending patents. Art Monk, applying the 3% rule (that around 3% of in-force patents in any portfolio are truly valuable) to both the Nortel and Motorola collections, believes Google has done well. "On just the basis of price per valuable patent it was a great deal, and the transaction also came with the cash on Motorola's balance sheet and the engineering staff responsible for patenting the inventions covered by the portfolio," he says. Not everyone agrees, though, and the wisdom of this purchase will continue to be debated. It seems reasonable to wonder, however, whether the Motorola purchase would ever have happened had the Nortel auction gone Google's way.

What it all means for patents

When news of the Nortel auction emerged, it made headlines around the world. One result is that the potential value of patents has been brought to the attention of every CEO of every fair-sized high-tech company on the planet. "Certainly one effect of the headline number was a realisation in boardrooms around the world that IP had more value than it had sometimes been given credit for," Berten says. "All the other operating business units of Nortel sold for US\$3 billion. We're talking about operating units that had billions of dollars in revenue and tens of thousands of employees sold for a collective US\$3 billion approximately, and there was IP included in those deals. But the remaining patents sold for an amount that was 50% higher than the rest of the company."

The flurry of patent sales in the immediate aftermath of the auction are only those that have been made public so far. IP insiders report that many more companies, large and small, are looking at their patents in a new light. Zenkich is among these: "We are being engaged by companies who have

seen the Nortel portfolio auction and the dollars associated with it and asked themselves the question: 'Should we be more aggressive in monetising our portfolio?'" he says. "What they are looking for is significant dollars beyond the traditional view, which was: 'Let's cover some of our patent prosecution and maintenance costs through patent sales.'"

One less welcome consequence is that it could potentially lead to company directors making rash decisions in an area they know little about. As Monk puts it, an effect of the headline figure is "everybody on earth saying, 'Oh my God, this patent I thought was worthless is now worth millions'". Zenkich warns against companies going to market without due care and consideration. "Selling patents – even if you're getting a one-time upfront payment, or some kind of upfront payment plus a back end – may in fact limit your strength, or limit the protection you get from that patent going forward," he says.

But it's not just patent-owning companies that are taking note. Laurie has also seen a spike in interest from investors. "I've been getting a load of calls from institutional investment firms who see this as the next big play," he says. "The interest has been incredible from parties that were sort of aware of patents, but didn't bother because the numbers weren't big enough. But we're now in hedge fund territory."

Given the stellar Nortel figures and the resulting scramble to sell attracting such attention, there has been – perhaps inevitably – some debate about the dangers of overvaluation, with the phrase "patent bubble" being used by some commentators. Laurie cautions against overoptimistic valuations. "People should be careful in extrapolating what happened to other situations. They may not involve standards or

Action plan



Many chief IP officers will no doubt have been fielding queries from the C-suite about buying and/or selling patents in the light of the Nortel auction and other recent IP-related deals. Most importantly, companies should not act in haste. Instead, they need to assess the situation thoroughly before committing to a transaction:

- Selling unused patents can be an excellent revenue driver, but may leave a company vulnerable in the future. If the company does not need the cash reserves, would it be more prudent to hold on to the patents?
- Patent portfolios need to be regularly reviewed and valued: Nortel arguably should have been more aware of the value of its own patents.
- Key patents and their strengths should be analysed and highlighted, so that prospective buyers understand the value of the portfolio.
- Buyers should understand that many factors affect the final selling price of a patent portfolio and each sale should be judged on its own merits.
- Strategic objectives of competing bidders may drive up prices and may be more important than the value of the patents. Potential buyers should beware of paying a high price for patents they don't need to practise.
- Companies with serious gaps in their own patent portfolios should address this problem sooner rather than later.
- In the case of purchase by a consortium, government departments may conduct an investigation into potential anti-competitive issues. They may also impose conditions on future use of patents.

the sort of arms race or nuclear confrontation between the iPhone and Android,” he says.

InterDigital claims that its patent portfolio is of an even higher quality than Nortel's. But now that the acute patent imbalance between Google and other smartphone players has gone following Google's Motorola Mobility acquisition, the strategic element of the overall value will have diminished. InterDigital's stock leapt when it announced a patent sale, but dropped again when the Google-Motorola deal became public. The InterDigital and Kodak portfolios are also thought to be more encumbered than Nortel's, which is likely to affect the ultimate price. Each patent portfolio will have to be judged on its own merits and it's unlikely that any will have the combination of advantages that the Nortel patents did.

Most likely, the Nortel patent auction will not trigger a frenzied patent bubble, but neither will it turn out to be a quickly forgotten event. Rather it is part – a very significant part, admittedly – of a trend of patents becoming more important in the boardroom and among investors. “If you have a curve of awareness that is ascending diagonally across the page, this might look like a little bit of a spike and a bit of a drop-off. It contributes greatly to the awareness among investors, among hedge funds, bankers – people who might not have spent as much time thinking about patent aspects,” says Monk. Steger has also noted patents becoming increasingly mainstream in recent years and says that the Nortel

result “can only accelerate that, because it's an eye-popping number”.

The story continues

The final fate of the Nortel patents is not yet known. Whether they will be divided up among the Rockstar Bidco companies or whether a pooling agreement will be reached may well depend on what the Department of Justice has to say about the deal following its antitrust investigation. Other patent sales, including InterDigital and Kodak, are ongoing at the time of writing, and more portfolios may well appear for sale in the coming months.

The impact of the Nortel sale on the patents landscape in 2011 has been extraordinary; whether repercussions will continue to be felt for years to come is not easy to predict. But while patents may drift out of the headlines, no smart CEO is going to forget that US\$4.5 billion figure any time soon. **iam**

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