

NOT ENOUGH MONEY

The Problem with Extracting Value from Patent Portfolios in the Gaming Industry

By Mark Lerner

All major manufacturers of slot machines and other gaming devices and systems have intellectual property programs. All hold dozens if not hundreds of issued patents in their portfolios. All file dozens if not hundreds of patent applications every year. All spend money – often millions of dollars each year – to maintain and expand their patent portfolios. Business acquisitions in the sector often are driven and valued at least in part by the intellectual property portfolios of the target companies.

Some manufacturers spend staggering amounts of money and other resources litigating or threatening to litigate against other manufacturers for purported patent infringement. They do this to discourage other manufacturers from marketing competing products or to extract damages or royalties from them.

These efforts have generally not succeeded in any substantial way. Sometimes they have failed spectacularly. Patent infringement litigation brought by gaming manufacturers has frequently resulted in findings of non-infringement. Some litigation has ended in judgments invalidating the owner's patents, rendering them worthless and wasting the time and money spent on patent acquisition and litigation. Plaintiffs as well as defendants are subject to the disruptions of litigation, as their officers and employees are deposed and their confidential business and financial information is produced to competitors in discovery proceedings and at trial.

Even in cases where litigation can be deemed “successful,” the royalties or damages extracted may

not cover the millions of dollars in attorneys' fees and other patent litigation costs. Fees in patent litigation are awardable at the discretion of the court only in “exceptional cases,” a difficult standard to meet. Even if it is met, the amount of the fees awarded is discretionary, so it's quite possible that an award will not cover the full amount. Furthermore, patent litigation in the gaming manufacturing sector has rarely resulted in injunctions that exclude gaming products from the market. And licensing programs have not generated enough money to justify the associated portfolio acquisition, maintenance, administration, and enforcement costs.

The nature of the gaming sector dooms efforts to extract meaningful returns from intellectual property through litigation or licensing programs. There simply is not enough money to draw from. This can be illustrated by comparing the gaming sector to other technology sectors where companies have been able to profit from their portfolios. Suppose that Dell wants to license IBM's portfolio of personal computer-related patents. Dell sells millions of units to millions of customers every year. Let's say the average selling price per unit is \$500. A 5 percent royalty for the entire portfolio would generate a relatively modest \$25 for each unit. Yet IBM would make tens, if not hundreds, of millions of dollars each year from this one license to one manufacturer. In addition to earning royalties from established competitors, aggressive enforcement and licensing programs can discourage startups and help preserve market share. The reach and versatility of portfolios in unregulated technology sectors offer licensing opportunities in other unregulated industries and sectors as well.

Contrast this to the gaming manufacturing industry. Slot machine manufacturers do not have millions of customers. There are fewer than 1,000 casino operators worldwide. Only a fraction of them buy significant numbers of products each year. Slot machine manufacturers don't sell millions of units. Industry analysts estimate that in North America all manufacturers placed about 62,000 machines in 2010 and 68,000 in 2011. The largest number of machines placed by any single manufacturer in either year was around 24,000, with the other major manufacturers placing fewer than 16,000 each. Even factoring in sales outside North America, it is clear that the volume is several orders of magnitude less than in other technology sectors.

In these circumstances, a reasonable royalty won't yield much. If calculated on revenue, a 5 percent royalty for a company that places, say, \$1 billion worth of machines would be \$50 million. But that assumes the royalties would be due on all machines. Features for which a license might be required are not likely to be present on every machine a manufacturer makes. Real world examples include instances where there were fewer than 3,000 accused products in the field, another where the number was less than 400, and still another where the total revenue earned from the accused products over several years was less than \$15 million. In each of those cases, the total aggregate royalties at 5 percent would not exceed \$2 million. Even a generous 10 percent royalty would not yield enough to justify the patent prosecution, administration, and enforcement costs, or the risks associated with litigation.

Returns are further limited where the royalty is calculated on less than the whole value of the slot machine. Due in large part to the product approval processes in the gaming industry, the rate of technology change is slow, and most inventions are incremental. If, as is often the case, only a minor feature of a device or system infringes, then damages or royalties are likely to be calculated on the value of that feature rather than on the value of the entire device. To use a mundane, non-gaming example, if a windshield wiper infringes a patent, the damages and royalties should be based on the value of the wiper, not the price of the car. Returns also go down if manufacturers implement non-infringing workarounds, as is likely to be the case in the gaming sector. Workaround implementation cuts off damages and royalties.

Within the gaming industry, there are not that many licensing opportunities. Unlike the PC industry where there may be dozens or hundreds of manufacturers from which royalties might be sought, in the gaming industry there is only a handful. The value of opportunities that do exist is offset by the portfolios held by the potential licensees, competitors who can be expected to counter with royalty demands of their own. Few licensing opportunities exist outside the gaming industry. Patents held by gaming manufacturers tend to be industry-centric with little utility to non-gaming manufacturers.

Thus, a patent holder is not likely to get enough money from aggressive enforcement or licensing programs to cover the costs and risks of litigation if the manufacturer of the accused product aggressively defends. Similarly, the costs of administering a licensing program could quickly gobble up company resources disproportionate to the revenue to be derived.



Another possible benefit of aggressive patent enforcement is that it can serve as a barrier to entry. However, in the gaming space this operates mainly to thwart existing competitors rather than to keep out new ones. In unregulated technology sectors, someone with a modest amount of money and equipment can develop products that compete with the larger companies. For such startups, the prospect of running a gauntlet of patents held by established industry behemoths is daunting and may be the most significant barrier to entry. In the gaming industry, on the other hand, the licensing requirements and product approval processes already create barriers to new manufacturers seeking to enter the market. While patent enforcement may supply incremental protection against new competition, it does not furnish enough additional protection to justify the costs and risks of a patent enforcement policy.

Licensing strategies might work if the patent holder demands royalties in amounts on a scale with costs of defense, discounted to adjust for the uncertainties and risks of litigation. Faced with such a proposal, the manufacturer of the accused product may be inclined to pay for a license to minimize risk and expense. Unfortunately, in many cases the patent holders' expectations are unrealistic, and they demand amounts many times greater than the profits (in some cases, greater than the total revenue) earned from the alleged infringing products. Inflated demands by intransigent patent holders often make litigation the mathematically correct choice for the manufacturers of the accused products.

Thus, licensing programs are usually not availing because of unrealistic expectations of the patent holders compared with the relatively small amounts of money they can realistically expect to get. And enforcement through litigation can be a high-risk, low-reward proposition for the patent-holder plaintiff. The defendant has risks, too, but the defendant also has the ability to mitigate by developing workarounds or, in the worst case, ceasing production of the accused products. If the plaintiff's settlement demands are many times higher than the expected costs of defense, the defendant that can afford to bear the burdens of litigating over several years will generally be better off doing so. In short, while a gaming manufacturer might be able now and then to score a modest hit with a patent enforcement or licensing strategy, in the long run these strategies have not demonstrated a positive return, let alone a return on equity equivalent to the manufacturer's core business. There simply is not enough money in the system to make either strategy worthwhile.

So does this mean it is pointless for manufacturers to pursue patent programs? Not at all. A portfolio may have value even though it does not generate cash flow. Experience has demonstrated two ways to extract value from gaming sector portfolios. One is for defense against competitors who aggressively assert patent infringement claims. The accused company's portfolio can be used to offset royalty demands and otherwise to negotiate to a resolution. This defensive use of a patent portfolio mitigates losses rather than furnishing positive value.

The second and more beneficial method is to cross-license portfolios with other manufacturers.

Cross-licensing furnishes positive returns and perhaps the greatest value achievable from a portfolio. Cross-licensing leverages the manufacturer's portfolio to obtain the use of competitors' portfolios, reduces development and manufacturing costs, and eliminates the costs and risk of litigation with that competitor. Manufacturers must spend considerable resources to avoid infringing on competitors' intellectual property. There are internal and external costs for patent and product searches and infringement and validity analyses. There are internal costs for altering product plans or developing workarounds to avoid infringement or reduce infringement risks. Moreover, even the most cautious manufacturer can be surprised, and product plans and investments disrupted, in a legal system where patent applications do not become public until eighteen months after they are filed.



Photo Credit: Brian Jones / Las Vegas News Bureau

These costs are difficult to isolate and measure with precision. But it is beyond refutation that eliminating these costs could save gaming manufacturers significant amounts of money each year. In addition, if manufacturers can be freed to develop products without fear of patent litigation by competitors, they will benefit from an overall reduction of costs associated with research and development. It will be unnecessary to pay lawyers to conduct costly infringement and validity analyses. Developers will not have to create workarounds and can bring products to market that much faster. Reducing or eliminating the risks and costs of patent litigation would save companies millions of dollars. If the threat of litigation is reduced, companies can scale back their patent application programs and realize further savings. Companies that can reduce or eliminate costs and risks in this way while gaining access to broader patent portfolios are likely to produce better products at greater profit and show immediate bottom line improvement. If a company can use its patent portfolio to accomplish these results, it will have realized more value from its portfolio than it is likely to achieve through litigation or a licensing program.

A cross-license (an agreement not to sue may accomplish the same objectives) costs next to nothing to implement. Little or no administration is required. Cross-licensing does not mean giving away technology. A license just means that marketing an otherwise infringing product will not result in liability. The other party still has to develop the product. A cross-license does not even necessarily entail identifying one's patents to the other party. Thus, each party would have almost two years' head start on development before the other party would even know about a patent. Parties can also choose not to patent some inventions and avail themselves of the legal protections applicable to trade secrets.

Cross-licensing does not have to jeopardize manufacturer and product identity. The cross-license can be limited to utility patents that cover game mechanics and electronics. Design patents covering "look and feel" features that distinguish manufacturers' products to the player can remain protected, along with copyrights and trademarks.

Cross-licensing also does not require complex valuation equalization formulas. Cross-licensing discussions can easily break down if the parties try to come up with a complicated way for one party to compensate the other for perceived disparities in portfolios. The difficulty stems in large part from companies' proclivity for undervaluing other companies' portfolios while overvaluing their own. Each company thinks it is most likely to come up with the next great idea, even though fundamental probabilities dictate that it is more likely to come from one of several competitors. A portfolio with one hundred patents is not necessarily one hundred times more valuable than a portfolio with only one. One patent can be just as valuable as one hundred, if it's the one you need.

Equalization entails continuing evaluation and administration headaches if patents are to be added to the cross-license over time. Also, over time the company with the larger portfolio will benefit disproportionately from the ability to scale back its patent application program, which will serve to bring the numbers of patents closer to parity. By and large, trying to equalize value is fruitless. Any reasonably-sized portfolios held by companies with active patent prosecution programs will be close enough in value that most disparities will be overcome by the benefits of a cross-license agreement.

Overall, the value to be derived by gaming manufacturers from cross-licensing their patent portfolios exceeds the returns likely to be gained from litigation or aggressive licensing programs. There is not enough money to be made especially after costs and risks are factored in. However, the value of the non-adversarial approach is not just about saving money. The freedom to develop that cross-licensing affords means better, more innovative products brought to casinos faster by manufacturers as they continue to compete with each other for market share. But with cross-licensing, the competition takes place in the marketplace, not in the courtroom.

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