A Framework For Choosing Between License and Exclude: A Case Study

by Bruce L. Beron, Ph.D.
Litigation Risk Management Institute
34 Coquito Court, Menlo Park, CA 94028
650.854.1914 Fax: 650.854.2417
bruceberon@lrmi.com www.litigationriskmanagement.com

Brief Summary
The client was MicroPharm, a small pharmaceutical company with good patent protection in a profitable market niche, which it dominated. Another small player, Intruder Drugs, trying to expand into that niche, had a new, much improved product which counsel thought infringed one of the company's key patents. If MicroPharm sued in an attempt to exclude Intruder from the market, Intruder would almost certainly file a counter-suit for infringing one of their patents. All of the combinations of MicroPharm's patent being valid, Intruder infringing it, and Intruder's patent being valid and infringed by MicroPharm would have widely varying impacts on MicroPharm's market share, margins, licensing fees and revenues. In particular, if Intruder were found not to infringe MicroPharm's patent and MicroPharm were found to infringe theirs, the company would not likely survive. Of course, there would also be significant litigation costs.

The General Counsel had to choose among three courses of action to recommend to the CEO: do nothing, enter a cross licensing agreement, or sue for infringement to try to exclude Intruder. The difficulty of evaluating all the possible business and legal outcomes of the three alternatives seemed daunting, and with the entire company potentially at risk, the GC knew that she needed a systematic, logical process to get to the right recommendation, one that would enable them to communicate clearly the rationale for the choice to senior management and the board.

The customary decision in situations like this, when there is a threat to the survival of the company, would be to negotiate a license using the threat of litigation as leverage. Litigation Risk Management/Settlement Valuation helped the general counsel show senior management that the best alternative was to attempt to exclude Intruder by suing, even though there was some small likelihood of a disastrous outcome. Counsel could also make them understand that the events leading up to this catastrophic outcome could be monitored and that they had effective contingency plans to further reduce its likelihood.

A Real World Problem
MicroPharm, a small pharmaceutical company had good patent protection in a profitable market niche, which it dominated. Another small player, Intruder Drugs, trying to expand into that niche, had a new, much improved product which counsel thought infringed one of the company's key patents. The General Counsel had to choose among three courses of action to recommend to the CEO: do nothing, enter a cross licensing agreement, or sue for patent infringement.

If they did nothing, their margins and market share would erode over time more rapidly than they would have if they maintained their protective posture. If they cross-licensed, they would have been letting a competitor into their market, but would still have been able to have some small measure of control and would have extracted some of the licensee's profits.

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How should the GC choose among the three alternatives? The first step in the process is to build a simple influence diagram (Figure 1) to make sure that all the major factors that can influence the outcomes have been included and to understand the relationships among them.

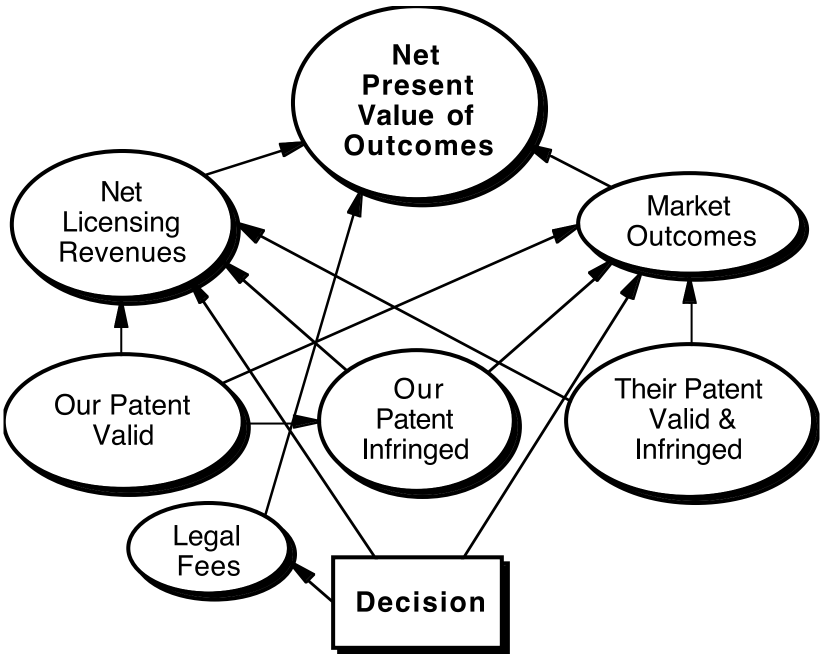

Figure 1: *The Influence Diagram shows the relationships among the issues that affect the outcomes.*

The next step is to construct a decision tree (Figure 2) to help lay out the alternatives, the possible outcomes and their consequences. The litigation decision tree displays the probabilities of the events and outcomes obtained from the appropriate counsel and business and marketing people. The expected value (the probability weighted average) of each alternative can then be calculated to use in the decision-making process.

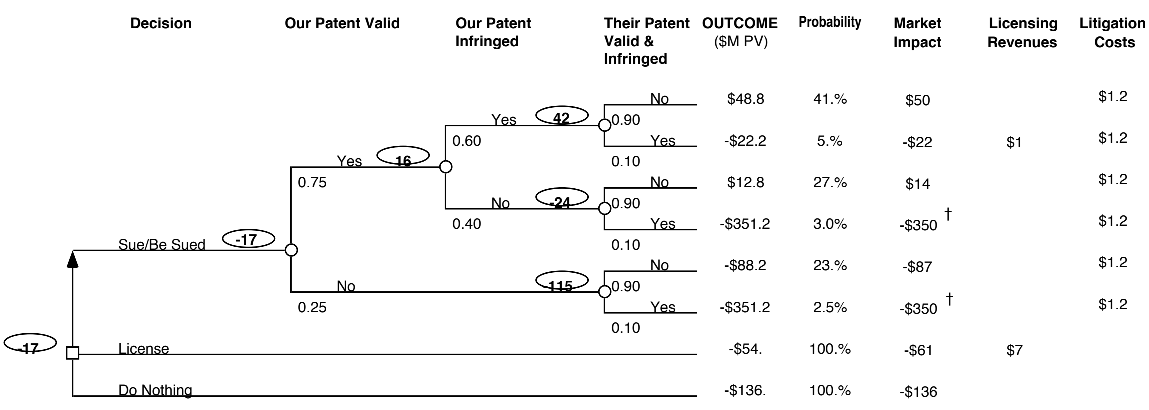

Figure 2: *The Litigation Decision Tree is a strategic map of the problem that shows the possible combinations of the critical factors, their probabilities, the outcomes, and the expected or average outcome for each alternative.*

The litigation decision tree shows that the expected <u>loss</u> for "Do Nothing" is $136 million; for "License," $54 million; and for "Sue/Be Sued," $17 million. The tree also shows that there is about a 5% chance of essentially losing the company if the competition did not infringe MicroPharm's patent and MicroPharm was found to infringe the competitor's.

One can also generate a probability distribution to show the range of outcomes and their likelihoods (Figure 3). This distribution shows some small chance of a big loss, and a broad range of possible outcomes from -$150 million to $125 million.

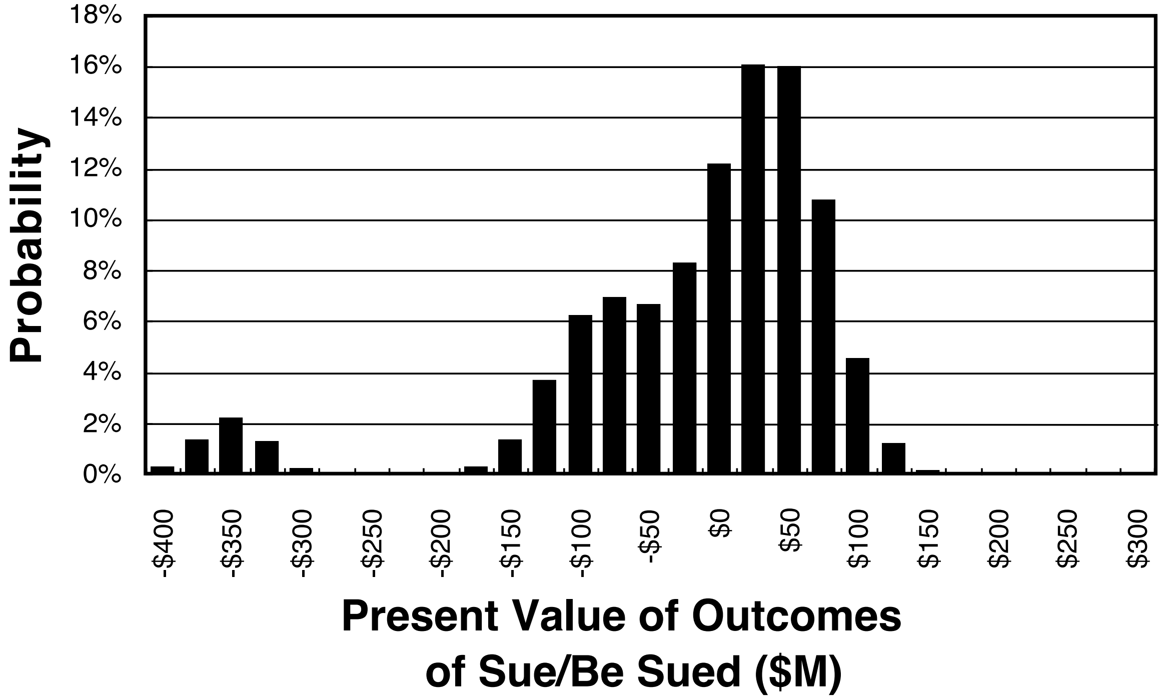

Figure 3: *The Probability Distribution graphically displays all the possible outcomes and their likelihoods.*

The customary decision in situations like this, when there is a threat to the survival of the company, would be to negotiate a license using the threat of litigation as leverage. Litigation Risk Management/Settlement Valuation allowed the general counsel to show senior management the particular threatening scenarios that could lead to the disastrous outcome, as well as their likelihood (~5%). Counsel could also make them understand that the events leading up to this catastrophic outcome could be monitored and that (with further analysis beyond what we have room for here) effective contingency plans existed which could be executed in a timely manner.

Furthermore, the contingency plans would reduce the probability of the disastrous outcome to less than 2%, and raise the expected value of "Sue/Be Sued" by $7 million. With this information, and knowing that their own judgments had been used for the business impact analysis, the CEO and the Board felt comfortable, in fact confident, about proceeding with the litigation.

The court ruled that, while MicroPharm's patent was valid, it was not infringed, nor did they infringe on Intruder's patent. They could not prevent Intruder from entering the market, but the finding that the patent was valid strengthened their hand in dealing with other potential competitors. Overall, the net gain was $67 million over the conventional decision to license.

