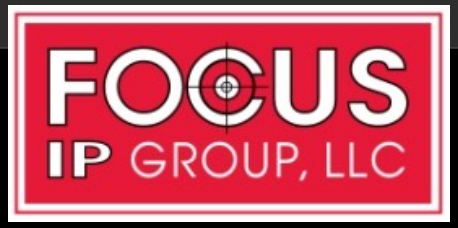
TLO Budgeting

Dr. Ashley J. Stevens
President



Agenda

- Income Budgeting
  - License income forecasting
    - Income distribution
  - Data sources
  - Auditing
- Expense Budgeting
  - Patent cost budgeting
  - Personnel cost budgeting
    - Salaries
    - Bonuses
  - Operating costs budgeting

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Income Budgeting

- Licenses have a variety of payments
  - Some defined payments, pre-commercialization
    - Upfront fee
    - Patent cost reimbursement
    - Developmental milestone payments
  - First two will certainly be received
  - Receipt of each developmental milestones depends on:
    - The license agreement remaining in effect
      - Previous developmental milestones being met
      - Market remaining attractive
    - That step in the development pathway being successful

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Income Budgeting

- Licenses have a variety of payments
  - Some defined payments, post commercialization
    - Sales milestones
  - Timing of receipt of these depends on:
    - The product being approved
    - The extent of the product's success

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Income Budgeting

- Licenses have a variety of payments
  - Some payments that depend on extent of the product's success
    - Royalties
      - The amount received in each payment period depends on the level of the product's sales
      - The deductions from gross sales to get to Net Sales

Income Forecasting

- Forecasting income under a license depends on having good data
- First source will be licensee reports
  - Annual reports pre-commercialization
    - Or more frequently if negotiated as part of the license
      - Maybe six monthly pre-commercialization
  - Quarterly reports post-commercialization
  - With a start-up company, negotiate to receive additional information
    - All Board packages
    - Business plans for investors

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Income Forecasting

- Supplement by closely following the licensee's public statements
  - Press releases
  - Website
  - Presentations at conferences
  - Quarterly and Annual Reports
    - If public
    - Or country that requires all companies to file public reports
      - e.g., UK
    - Companies frequently publicly disclose quarterly and annual sales of individual products
      - Particularly if product is a major revenue generator
- Third source should be market research reports on that industry

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Auditing

- Finally, internal data from licensee via an audit
- Licenses should always include the right for the licensor to audit the licensee
  - To verify compliance with terms of the license

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“Trust but verify”

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Auditing

- Finally, internal data from licensee via an audit
- Licenses should always include the right for the licensor to audit the licensee
  - To verify compliance with terms of the license
    - Normally used to verify accuracy of payments
      - Milestone payments
      - Payments received from sublicensees
      - Sales
      - Allowable deductions from sales
  - Once per year
    - Up to 3 years in arrears
      - IRS records retention requirement
  - Reasonable notice
  - Time that is reasonably convenient to licensee

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Auditing

- By an independent accountant retained and paid for by licensor
  - May require that the accountant be a CPA
- Will be expensive
  - $35,000
- Audit provisions normally require licensee to reimburse licensor if an under payment of more than 5% in any payment is found
  - Pay attention to details when negotiating the license
    - Threshold for reimbursement
      - 5% vs. 10%
    - Annual amount due vs. any individual (quarterly) payment

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Auditing

- When should you audit?
  - Every 3 years if sales are $1 – 5 million/year
  - Every year if sales are >$5 million/year
  - If there's a discrepancy between what they're reporting to you vs. what they're saying in public
    - Level of sales
  - If there are excessive deductions from gross sale
    - Should be less than 5%
      - Biological drugs and vaccines may have shelf life issues and high returns
  - If payments stop the day the patents expire
    - License grant is to "make, use and sell"
      - They must pay royalties on the product they've made prior to patent expiration

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Putting the Income Forecast Together

- Should always aim for a forecast that is below what actually happens
  - "Stretchably conservative"
- Must anticipate failure of some licensees to successfully develop the licensed technology into a product
  - In drug development, there are studies and data on success rates of a drug candidate successfully progressing through successive stages of pre-clinical and clinical development
    - Apply them to likelihood of receiving milestone payments and running royalties
  - In other sectors, talk to licensee about their track record
- Present the big picture
  - Total income received by institution
    - Not just share retained by OTL

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Expense Budgeting

- Biggest challenge is patent budgeting
  - Patent budget generally ~50% of total OTL budget
  - Significant % of expenditures reimbursed by licensees
    - Sunk costs incurred prior to the license
      - Generally paid at closing
        - Start-up may ask to reimburse over 2-3 years if sunk costs are substantial
    - On-going costs of prosecution
      - Generally best for university to pay the law firm bills and immediately bill the licensee
        - Law firms tend to think of the person who's paying their bills as their client
        - Don't want them thinking of the licensee as the client
        - Their interests may be different from university's
      - Unless licensee is a start-up with limited cash
        - Let the law firm take the credit risk!

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Expense Budgeting

- Budget should be based on net expenses after all reimbursements
  - Suppose a licensee decides to patent extensively worldwide
    - Total patent expenses will go up
      - Net expenses won't change
    - University will benefit long term
      - Bigger royalty base

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Expense Budgeting

- At a major OTL, there will be thousands of law firm actions per year
  - Each one has a cost
    - Minimum billing time is generally 6 minutes (0.1 hours)
      - For a lawyer charging $600/hour, a short phone call costs $60
- Most OTL's negotiate either:
  - Fixed fees for each specific type of action; or
  - "Not to exceed"
    - Hourly rate up to a limit

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Expense Budgeting

- Biggest costs of patenting are:
  - Preparation and filing of initial patent application
    - Generally ~50% of total cost of getting a patent
  - National phase entry
    - 30 months after filling initial application
      - EPO
        - Substantial filing fees
        - Substantial annual maintenance costs
      - Japan, China
        - Translation costs

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Expense Budgeting

- US PTO fees generally reasonable
  - 50% reduction for non-profits and SME's
    - SME is company with <500 employees
    - If patent application is licensed to a large entity, no reduction
  - Micro-entities and universities get 75% reduction in fees
  - Maintenance fees at 7.5, 11 and 13 years after patent issuance
  - Late fees are significant and should be avoided
- PCT filing fees are reasonable
  - Maintains options for worldwide patenting for 30 months from initial filing
    - Will be very important to licensees

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Expense Budgeting

- Patent actions are reasonably predictable
  - Once a patent application is filed, there are predictable deadlines
    - e.g., If initial application is a US provisional application, one year later:
      - Conversion of US provisional application to US utility application
        and/or
      - PCT filing
  - Biggest variable is time to initial office action
    - The “Backlog”
      - Currently ~3 years in the US
    - When examination starts, examiner sets a time to respond
      - Can be extended by payment of late fees
        - Avoid at all costs

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Budgeting Process

- Iterative
  - What would we spend if we did everything?
  - What will the university let us spend?
  - Which cases do we want to spend it on?
- Continuous
  - Set budget and priorities prior to start of the budget year
    - Update monthly
    - Reset priorities
- Labor intensive
  - Requires substantial efforts by all members of the OTL
  - Requires substantial effort by law firms
    - Get them to agree to not charge for annual budgeting in Engagement Letter

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Budgeting Process

- Wild cards:
  - Which new licenses will be signed?
    - Availability of sunk cost reimbursement to offset new cases
    - Pressure to sign licenses increases as year end approaches
  - How many new initial patent applications will we file?
    - Number of new disclosures is predictable
  - What cases will we enter National Phase on without a licensee?
    - Universities never used to do this
      - Translational research programs can lead to it
        - University spends time developing the technology before seeking a licensee
        - Need to preserve worldwide rights to attract licensees

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Budgeting Process

- Steps:
  1. Identify all active cases
     - From the OTL's database
     - Confirm with law firms
       - Critical that the law firm use the OTL's case numbering system in all their bills and case names
  2. Identify all actions likely during the budget year
     - And the month they'll likely occur
  3. Ask law firm to give a "not-to-exceed" for each action
     - Based on case complexity, extent of examiner's objections
  4. Create spreadsheet with cost of actions by case by month
  5. Allow for reimbursements by licensees

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Budgeting Process

- Steps:
  6. Generate net budget
     - Generally will exceed what the university is willing to spend
  7. Office as a whole prioritizes the entire portfolio
     - Priority 1 — Will certainly do
     - Priority 2 — Will do if there is an upside event – licensee, unexpected reimbursement, etc.
     - Priority 3 — Will not do
  8. Calculate the Priority 1 net budget
     - Is this more than or less than what the university will spend?
  9. Reprioritize to increase or decrease Priority 1's as appropriate
  10. Recalculate the Priority 1 net budget
      - Repeat until Priority 1 net budget equals what the university is willing to spend

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Ongoing Budget Management

- Monthly reconciliation of budget with actual
  - Did the predicted action occur?
  - If not, when will it occur?
  - Did the predicted action come in over/under the budgeted amount?
  - Have there been any “wild card” events?
    - Surge of new, important inventions
    - New licensee
    - Final rejection by an examiner
    - License termination
  - Recalculate the net budget
    - Reprioritize if needed
  - Can “fine tune” year end outcome by accelerating/delaying actions in final 1-2 months

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Observations

- In US, scientists understand need for patents
- Universities therefore frequently have substantial patent expenditures even before they establish an OTL
  - These expenditures are frequently wasteful
    - No negotiation of preferential rates
    - Substantial foreign expenditures without a licensee
    - Continuing to prosecute improvements for too long
    - Late fees
    - Patenting inventions with low probability of licensing
      - “Vanity” patent for a powerful faculty member
    - Patenting the wrong thing
      - Not understanding what the commercial implementation will be

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Observations

- Establishing an OTL will generally rationalize expenditures
  - Triage and evaluation of inventions to ensure they are commercially viable
  - Managing prosecution
  - Negotiating preferential rates

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Other Operating Cost Budgeting

- Generally straightforward and predictable
  - Salaries
    - Evaluations and raises before start of budget year
  - Bonuses
    - Predictable before budget year starts
  - Operating costs
    - Travel
    - Tools and databases
      - Predictable

Questions?

astevens@bu.edu

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