

The Phelps perspective

As a pivotal figure in IBM's reworking of its intellectual property strategy, Marshall Phelps is a worthy entrant into the IP Hall of Fame. He is now helping to rework Microsoft's approach to patents

By **Liz Rutherford-Johnson**

Marshall Phelps helped put IP on the corporate map and made senior management, and Wall Street, sit up and take notice of IP as a revenue generator. He is credited with repositioning IBM from a tech company that made a few million dollars in IP-related revenue in 1985, to a licensing powerhouse making over a billion dollars a year from its IP in just over a decade. He is now head of IP at Microsoft, which has just celebrated the grant of its 5,000th patent by the United States Patent and Trademark Office.

Nearly three years into this role, Phelps talks about the work he did at IBM and about what he is now trying to achieve at Microsoft.

You put IP on the corporate map at a time when it was seen as an optional extra – was it a struggle to make companies appreciate the value of their intangible assets?

You only need one good idea in life and that was probably my one good idea. It really came about because I was watching IBM struggling in the late 1980s and trying to figure out what the company could do; how it should deploy its assets. It was becoming obvious to me that IBM had a huge IP portfolio and I didn't think we were getting a fair value from it at that time. I probably made a real pain of myself arguing that we, we at that point being IBM, should be taking better advantage of this huge asset. And finally the then CEO got tired of listening to this argument, so he told me to go ahead and give it a go.

But that was the thought I had: that companies were not valuing their intellectual property very well. I still don't think they are.

Part of the problem is that accounting rules haven't caught up with the assets – they never do until you have a sale and then it shows up as goodwill somewhere. It seems crazy that intellectual property worth millions and billions of dollars just doesn't show up on a balance sheet. But changing the accounting profession is probably even more difficult.

I think there are a number of examples of companies that have made good use of their IP portfolio; you can even argue that they've done it too well. But Qualcomm, Texas Instruments and DuPont have been very successful. I think certainly in terms of realising they have intellectual assets, the drugs companies are also pretty good at that. They don't monetise those assets in the same way as other companies because in their case a patent has a one-to-one relationship with the product – they develop a molecule and patent it, and that molecule equals the product. Whereas in my world I will have a software product with millions of lines of code or a chip with millions of different circuits, which might involve thousands of patents.

As a final word, the point is a very simple one: if you're going to have a broad licensing programme you need to be very flexible about it and you need not to be religious about it and you need to be able to carve up your portfolio in ways that are meaningful to the marketplace – and then you'd better have your examples to prove it.

Do you think that the market has a realistic appreciation of the value of IP yet? Is there any danger of IP becoming over-valued as an asset, leading to another crash like the dot.com bubble?

No, I don't think so, because I think it's very

much subject to market forces reflected in individual negotiations with other companies, who are pretty sophisticated as well. If anything the bias is still the other way. What happens is that you get a negotiation over the value of your portfolio versus the value of somebody else's and that breaks down pretty quickly if you can't agree on what that relationship is. If you overprice your asset you will end up in litigation because somebody will find it cheaper to infringe than to overpay on a licence. So there is that mechanism in the system – if you try to hold someone up irresponsibly you're going to end up in a courtroom and have a jury and a judge decide the value of the intellectual property. That's problematic for both sides, so generally speaking you try to work something out. Most people in my position would try to avoid litigation at all costs, though every now and then you can't.

Do you see Microsoft turning into the same licence-generating machine as IBM?

Microsoft has a very different business model to IBM. IBM built a collection of technologies – from PCs to software to disk drives to mainframes to services; at that time they did everything in the industry. So they had a wider range of offerings than Microsoft, which sticks to three main business groups – operating systems, office suites (what we call information worker suites) and the gaming side of it.

It was not clear until the mid-90s, even in the United States and Japan, that you were going to be able to have a free hand in getting software patents, so Microsoft was later to the game than IBM was. You have to remember that IBM is almost 100 years old as a company and Microsoft is just 25.

Microsoft only started getting serious about patenting in the late 90s and, frankly, I think one of the main reasons Microsoft hired me was to take a much more serious look at that and to up-tip the amount of IP filings and protection the company was seeking. In the United States we are now filing over 3,000 patent applications a year, which puts us in the top rank of the world. But it's going to take us a few years to catch up with the supply side of this.

Now on the other side of this, the licensing side, Microsoft makes most of its money already by licensing intellectual property. All its software goes out under a copyright licence, if you think of it that way, so its business model is already very intellectual property centred. I don't think Microsoft needs to follow exactly the same

model as IBM because it's already following its own model.

That said, I think there's an awful lot more that Microsoft can do. We started a sort of broad-brush licensing programme on 3rd December 2003 when we said we would talk to pretty much anybody about licensing anything we had. And we've done that. We've already done about 200 or so licensing deals since then of all shapes and sizes. And every time you do one of these arrangements, what you've done is changed your interface with another company.

Over time, licensing and putting technology out there for people to use willingly rather than having it happen because you're a *de facto* standard is a terrific way for a company to change its model and move it forward. I think you're going to see Microsoft continue to do that; we've got a long way to go but so far it seems to be working.

At the high end these sorts of deals involve trading off large portfolios with other people who have large portfolios, let's say in a licence agreement with Hewlett Packard or Intel. So you get access to their whole portfolio and they get access to yours. Then as you design your products down the road you don't have to worry about someone else's massive IP portfolio or the fact that you might be infringing it because you're allowed to use it.

At the other end we might develop a technology. A good example would be ActiveThink where we develop a program for cell phones to make them think better. In those kinds of case you go out and you do a programmatic licence for people who might want access to just that piece of technology but couldn't care less about your entire portfolio because they don't need it.

That's the key to it. You really cannot approach this as one size fits all and force the world to take it the way you want it. That may come as a surprise to people when they hear that from Microsoft, but that is the case. We are very much interested in adjusting our offerings so that other people want them, as opposed to making people think that they're being forced to take them in a certain way, driven by the market influence of Microsoft.

Is patent and licensing revenue the top of the food chain?

I actually don't think that revenue is at the top of the food chain; I think that the top of the food chain is trading intellectual property for technological advances. If you happen to

get some money for that, that reflects that you might have an offering that people want and are willing to pay for it.

There's a trade-off there when you trade your intellectual property; it means that somebody else doesn't have to pay for the R&D to get to the technical point you've already accomplished. They get there by licensing it from you, and it may be cheaper for them in time and money to do that. The trading of the intellectual property and getting it out there in the marketplace for humanity to use is the highest part of the food chain.

What are your thoughts on the challenge offered by the open source movement?

Open source is not going to go away – why should it? There's something nice about things that look like they're free. There are obviously other crosses associated with that but those are trade-offs that customers have to make. To a large degree we're already driven by what our customers actually want. Most of our sophisticated customers exist in what we would call a heterogeneous environment, as opposed to a homogenous environment, where they have software from all sorts of different sources.

My view is that both business models have to figure out a way to accommodate each other. I do believe that's possible and I do believe in forcing changes on both sides. For example, on the open source side you find many more commercial companies that base their business model on using open source software but then wrap services and support around that going forward. You see that everywhere – these are the Red Hats of the world. On the commercial side you're starting to see, and you will continue to see, far more accommodations made by commercial software companies to the concept of interoperability than you might have seen in the past, because the two worlds have got to work together and the customers are truly driving that.

Respecting the two different business models is going to be an interesting and an evolving situation but it is going to happen. Microsoft just did a couple of arrangements with J-Boss, which is an open source software company. So we're not at all averse to that.

Some of the things you hear, on both sides, are almost religious in nature. The language is a little bit over the top in a lot of cases. But I do think once a company is in this business to make money it tends to look at the world a little bit differently and I am starting to see some real

accommodation between the two sides. We have discussions all the time with open source companies and in the main they go very well. So I do see those worlds overlapping, I wouldn't say colliding, again driven by customers.

China is obviously a crucial market for Microsoft – do you think the high levels of piracy are likely to present an insurmountable problem to patents and licensing?

I'm just a wide-eyed optimist! China is now a member of the WTO. China has an immensely huge economy growing at 9.5% a year last time I checked. You can't take an economy that big and have it grow that fast and allow it to ignore international norms on this. My opinion is that over time these issues will resolve themselves. You have to remember that China has competition from the United States and from Japan – which care an awful lot about intellectual property – and now all of a sudden it has competition from India. And India, which is about the same size, has over the last few years become a very stalwart economic engine based on the rule of intellectual property: just like here in the United States. If I were China, I would be looking at how far India has come because and not in spite of IP rules. If you want the country to continue to attract investment and be competitive you have to take that into consideration and I think they will. China has pretty good IP laws; what they've got is lousy enforcement.

Is the lack of an international agreement on patents a big stumbling block for cross-border licences? Do you think this is something that will ever be resolved, given the current hiatus on the Community patent in Europe?

First of all I don't think companies are restricted in doing their licensing by whatever the laws are in any particular areas. Multinational companies build and sell their products around the world so they're going to do licence agreements irrespective of what's going on in a particular jurisdiction. Having said that, there is a great need for as much harmonisation of IP laws as we can get – and we're not there yet.

Europe is having trouble harmonising itself even – and that was your point about the Community patent, which is now starting up again. It will be interesting to see where that goes or whether it will just drag up all the old arguments the CII Directive did a year ago. I would argue that it's probably too soon and the wounds are too fresh but we'll



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see. With the EU now at 25 members and with companies faced with the burden of translation costs in up to 20 languages each time they file a patent, Europe has really got an uncompetitive situation going for itself.

But my personal view is to ask, why aren't the mechanics of getting a patent given the same full faith and credit in each jurisdiction in the world? Let me give you an example – why shouldn't a prior art search done in Japan be valid in Europe and valid again in the United States and vice versa? Why do we have to pay for the same search three different times just in those three jurisdictions? Well the answer is, of course, that there are infrastructures that make money doing that. However, I do think that these are the kinds of arguments over harmonisation that are important and over time will win out. Already there are, I would say, fairly nascent attempts at harmonisation at regional levels, in South East Asia or Central America.

I do think there are efforts all along the line; they should be applauded and I think the big industrial parts of the world should get behind them and promote them.

Do you think that the growth of US bilateral free trade agreements is something that might help promote that?

Absolutely; and I think the whole WTO thing is too. The more of these treaties we have like TRIPs the better. They're all just really attempts to get technology all on the same footing. I'd be optimistic about that, though I wouldn't expect anything to happen fast – these things are slow as molasses. Jurisdictions change, politicians get voted out of office, new people come in and what do you do each time? You sort of restart it all. That's kind of the way it works.

What do you think are some of the main challenges as well as the opportunities, being faced by the IP sector in the immediate future?

One of them is this question of harmonisation. Another one is always to maintain balance in the system. By that I mean don't overreach, because that just earns you the enmity of your competitors or governments. A third one for me would be, always make sure you have a system that keeps up with technology – that takes a while because technology moves pretty quickly. I guess the fourth thing I would say is that you shouldn't use these systems for your regional competitive or anti-competitive purposes, which happens all the time though.

I do think these kinds of national/international normative legal programmes are really important because they establish ground rules for the world to compete at the right level, they provide ways to get ideas and technology out there, and they reward people for having invented them. One way to think about the IP systems in the world, and I don't care which one you want to pick, is that they are marvellous private incentive programmes in some way, shape or form.

You need those incentive programmes so that people are motivated to invent at the end of the day. You can do an awful lot in a cooperative development model but I don't know that that continues forever that way. It might but in any event I don't see anything wrong with the private mechanisms because I think you can go back and look at the competitiveness of the United States, for example. And it's really hard to deny that the IP system hasn't had a lot to do with where the United States now finds itself today.

So I would look at that rather than, say, a model that says: let's not respect intellectual property, we can have access to everyone else's IP for free. There are countries that say that but it's like a one-time vitamin pill for your economy. Nobody's going to invest in that after it happens. If you were a drug company and your drug was basically taken away by the government, why would you ever build a plant in that country? You might not even market your product there.

I went to visit a drug company in the Seattle area – one of Microsoft's senior people was on the board and they asked me if I would go. They were telling me that the day this particular drug was announced – the day – counterfeit copies were available in India and China. Now their point is, why would you ever bother in those countries if that's what happens? So I think it's a problem, but I do think it's remedial and I'm more optimistic than pessimistic that these systems are going to hold. Don't forget that the patent system in the United States is a couple of hundred years old and it's still working pretty well. There are still things we can do to make it better, but 200 years is pretty good. ■

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