# Soft•letter

## RIM vs NTP: The Fallout

*The RIM vs NTP battle seized the public's imagination as the case wound on and on and it seemed possible that hordes of screaming Crackberry addicts, unhinged at their loss of 24/7 access to text-based E-mail, would soon be unleashed like a Zombie plague on an innocent public. Oh, the horror of it all. Thankfully, we can all relax now that the Canadian company has settled.*

*The case has caused a lot of hand wringing among the high-tech press and a fair amount of reporting that we think is misleading. While reporters spent a lot of time positioning RIM as the victim of a patent troll, few bothered to point out that the entire case was sparked by RIM's filing of a patent lawsuit against rival firm Glenayre Electronics. It was news of this case that inspired NTP to file its own suit in the courts. Nor have many noted that RIM itself has a policy of aggressively filing patents and protecting its own IP.*

*To help shed light on recent events, we spoke with Mr. Rory J. Radding, head of the New York IP/Patent Group at Morrison & Foerster LLP. Mr. Radding has extensively litigated diverse patent, trademark, copyright and trade secret cases, acting for both plaintiffs and defendants, involving plastic manufacture, electrochemical devices, ring laser gyroscopes, avionics, communications, pharmaceuticals, computer controllers, data compression, impact sensors, bicycles, candy, wine, personal consumer products and television commercials, to name a few.In addition, Rory has developed complete global strategies for several telecommunications, Internet related companies and a consortium of worldwide banks concerning security for e-commerce.*

**What are the three primary lessons a software company should learn from the RIM vs NTP affair?**

First of all, do your due diligence, particularly if you're a larger or successful company that's in the public eye. RIM certainly was no stranger to the patent game and when they were contacted by NTP they should have immediately taken a look at NTP's patents. They were slow to do so and it cost them a lot of money in the end.

The second thing a software company needs to do is design workarounds for key technologies in advance or at least when the company receives the warning letter. I've been involved in cases where this wasn't difficult, involving some fairly straightforward changes to code. *(continued on page three)*

## Increasing Q&A Costs Squeeze Bottom Lines, Part I of II

*by Merrill R. Chapman*

Last year as part of my work as a Codies 2005 judge, I tested a popular desktop utilities package and was not pleased with the experience. The program crashed and burned when the CD eject button was hit while installing, something any retail application should be able to handle. Then the package hosed my test system while supposedly cleaning up my registry; complete a reinstall of Windows was required. By the time I was done with my evaluation the software had received a poor rating from me and the other judges. The product had clearly not been vetted by good Q&A team.

I did some research into the application's development via a contact at the company and discovered that this version of the software had been Q&A tested in India while most development had been done in the US. (I also found out that the firm was aware of the problems with the application and that Q&A had been moved back to the US.) Over the past several years we've tracked several software companies that have attempted to offshore their Q&A while keeping core development in the US. In the main, the experiments have not been successful. Development and Q&A seem to need to be in close physical proximity to work effectively together; those companies who are happy with offshoring their Q&A have also chosen to move their development overseas as well.

Regardless of where it takes place, the cost of providing Q&A in the software industry is rapidly rising, with salaries for Q&A personnel ranging between $55K to $100K (a Mercury specialist). While a lot of attention has been paid to development being offshored, the cost of testing has escaped comparable scrutiny. That's a mistake, as this recent quick "snap" poll of a select group of software firms we surveyed demonstrates:

| Company Size | Development | Q&A |
|---|---|---|
| 10M+ | 70% | 30% |
| 50M+ | 65% | 35% |
| 70M + | 55% | 45% |

Our results back up an NIST report developed in 2002, which stated that the cost of testing accounted for 50% of the total cost of developing a software product (the report focused on costs for larger firms). We believe the lower costs we see for smaller companies reflects the fact that they are building less complex products and that development staffs are doing dual duty both as coders and testers.

Agile methodologies have been touted as an answer to rising Q&A costs and at the component level, some of the companies we've spoken to are happy with the results they're seeing. However, every firm we've spoken with is less enthusiastic when the issue of integration testing is raised. Agile has problems coordinating the small, independent teams it advocates to build products with active end user input. One developer we spoke with pointed out that corporate politics usually dictate that functionality be retained and unit tests decreased when a choice between the two has to be made.

The third point is that if you're a company of any size, you need to have an IP strategy in place. Consider patenting not just key elements of your technology, but technology in markets where you may want to compete in the future, technology that may be used by your competition, even technology that you may not use but that can be used by others.

**A lot of the discussion about the case focused on the fact that the patent office reversed itself on the NTP patents. During the trial RIM did something that reminded a lot of people of what Jim Allchin did during the DOJ case, where he showed a purported video of how Windows slowed down when IE was removed, only to have the video exposed as being doctored. During the NTP case, RIM "demonstrated" a text messaging system that was supposed to predate the filings of NTP's patents, then had to own up to the fact they were using updated software to run the test.**

This would probably have been a good time for RIM to have considered settling. I've been involved in many cases where a company attempts to create demos that establish prior art. It can be very difficult, and it is very dangerous to make a mistake. I've seen chemical companies attempt to show prior art and forget to use compounds and substances that would have existed during the period under dispute. A trial is often a question of credibility and making a mistake like that can destroy your credibility.

**Should RIM have settled?**

Earlier than they did? I think it would have been a very wise thing to do. It was a matter of timing. In their case, it was a race between the courthouse and the patent office. NTP filed in the federal Eastern District of Virginia, that's the "Rocket Docket. They move cases along smartly. Had the case been filed in a "slower" district, RIM might have won the race. BTW, if as a plaintiff your strategy entails getting to a trial quickly, the Eastern District of Texas is also a fast docket.

**Why did the judge insist on pushing the case to settlement when it became apparent that the patents would be invalidated?**

The impression everyone has is that the patents have fallen. They haven't. First, NTP can take the matter to the Board of Patent Appeals in the patent office; if that fails, they can then take the issue to the Federal Circuit Court. The appellate process won't be over for at least a couple of years.
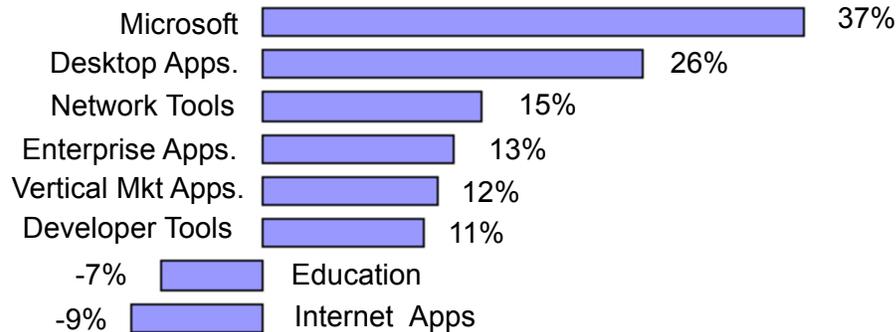
Another point few have made is that NTP can also narrow or refine the scope of their patents in response to USPTO rejections. The patents might, or might not, still apply to RIM. However, time was against RIM. They needed to settle this case.

**The press made wide mention of the fact that the presiding jurist, Judge Spencer, granted NTP an injunction that put pressure on RIM; many commentators thought** *(continued on page six)*

> **"I do think it's time for Congress to introduce an "Omnibus Innovation" act and revamp IP laws to conform to the 21st century in a fashion similar to what happened in 1952."**
>
> *—Rory J. Radding*
> *Morrison & Foerster*
> *LLP*

## Operating Income Ratios Up in 2005

| | |
|---|---|
| Microsoft | 37% |
| Desktop Apps. | 26% |
| Network Tools | 15% |
| Enterprise Apps. | 13% |
| Vertical Mkt Apps. | 12% |
| Developer Tools | 11% |
| -7% | Education |
| -9% | Internet Apps |

## Benchmarks: Operating Income

Operating Income is Gross Profit less Operating Expenses, and is found in the Earnings Statement or Statement of Operations in the annual financial reports of corporations. The 10-K forms filed annually with the SEC are Softletter's primary source for this information. Operating Income is also called Operating Profit or Recurring Profit. It is not "Net Income" because it is calculated before taxes and interest (either positive or negative) are added into the income statement. The Operating Income Ratio is simply this "Earnings before Interest and Taxes" (EBIT) divided by Sales (or Net Revenue).

Operating Income provides the funds beyond those needed to cover operating expenses, funds that are essential to a business's growth and development. A higher Operating Income ratio implies that a company is running more efficiently; whether it is more profitable or not depends on whether this surplus income is used to invest in the future or disbursed now as profits.

Softletter's figures give the ratio for each of the Benchmark 50 companies for each of the three years covered; figures for industry segments (and the entire group) are means of those ratios, but the final column represents a three-year average of company and segment figures in the columns.

This year (2005) provides ever-stronger figures for industry recovery. The truly bad years (2001-2003) are behind us, and the Benchmark 50 managed an 8.9% Operating Income Ratio for the year. Over the past three years the big winners are Microsoft (20.4%), Desktop Apps (14.8%), and Development Tools (10.6%); the big loser among the segments is over those three years is Internet Applications (-32%). Education managed to break even (0.1%).

We will continue to see consolidation. In Internet Apps, Centra (-30% over the three years) has just been bought by Saba, and in Network Tools, Tarantella (-99% over the same period) has been acquired by Sun.

*Data for this analysis has been drawn from the Benchmark 50, a group of 50 public software companies whose financial results are broadly representative of trends in the software marketplace. The 50 companies are divided into seven product- and market-related segments, plus Microsoft in a category of its own.*

# The Benchmark 50: Operating Income

| | Revenues (000) | | | Return on Equity | | | Avg. |
|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2003 | 2004 | 2005 | '03-'05 |
| **Microsoft** | $32,187,000 | $36,835,000 | $39,788,000 | 0% | 25% | 37% | 20.4% |
| **Desktop Applications** | | | | 1% | 18% | 26% | 14.8% |
| Intuit | $1,597,071 | $1,802,224 | $2,037,703 | 21% | 23% | 26% | 23% |
| Macromedia | $336,913 | $369,800 | $436,168 | 1% | 13% | 13% | 9% |
| Adobe | $1,294,749 | $1,666,581 | $1,966,321 | 29% | 36% | 37% | 34% |
| Symantec | $1,406,946 | $1,870,129 | $2,582,849 | 24% | 27% | 32% | 28% |
| IMSI (Int'l Microcomputer) | $8,095 | $10,017 | $13,874 | -34% | -38% | -29% | -33% |
| Nuance Commo. (Scansoft) | $135,399 | n/a | $232,388 | -5% | n/a | 1% | -2% |
| Smith Micro | $7,131 | $7,216 | $13,316 | -25% | -13% | 26% | -4% |
| **Vertical Market Applications** | | | | 3% | 11% | 12% | 8.6% |
| Autodesk | $824,945 | $951,643 | $1,233,677 | 3% | 11% | 19% | 11% |
| Moldflow | $36,625 | $48,673 | $64,418 | 0% | 6% | 10% | 5% |
| Ansys | $91,011 | $113,535 | $134,539 | 30% | 27% | 34% | 30% |
| Advent | $159,436 | $137,159 | $149,990 | -10% | -29% | -12% | -17% |
| Dendrite | $225,756 | $321,107 | $399,197 | 11% | 11% | 12% | 11% |
| MapInfo | $106,255 | $124,673 | $149,424 | -2% | 9% | 11% | 6% |
| Kronos | $397,355 | $450,694 | $518,658 | 14% | 15% | 16% | 15% |
| **Enterprise Applications** | | | | 1% | 3% | 13% | 5.9% |
| Concur | $56,737 | $56,550 | $71,831 | 1% | 3% | 7% | 4% |
| Manhattan Associates | $175,721 | $196,814 | $214,919 | 80% | 85% | 85% | 83% |
| Knova Software (ServiceWare) | $10,158 | $11,511 | $12,502 | -56% | -9% | 13% | -17% |
| Mercury Interactive | $400,122 | $506,473 | $685,547 | 17% | 10% | 14% | 13% |
| Witness Systems | $67,686 | $108,037 | $141,335 | -2% | -20% | -6% | -9% |
| SPSS | $208,480 | $208,367 | $224,074 | -8% | 0% | 3% | -2% |
| Business Objects | $454,799 | $560,825 | $925,631 | 73% | 76% | 70% | 73% |
| **Internet Applications** | | | | -69% | -19% | -9% | -32.0% |
| Cryptologic | $34,427 | $44,211 | $63,714 | -6% | 24% | 26% | 15% |
| RealNetworks | $182,679 | $202,377 | $266,719 | -17% | -10% | -9% | -12% |
| NetIQ | $264,138 | $217,000 | $213,216 | -113% | -72% | -11% | -65% |
| Verisign | $1,221,668 | $1,054,780 | $1,166,455 | -393% | -22% | 11% | -134% |
| Ultimate Software Group | $55,149 | $60,416 | $72,028 | -26% | -15% | -7% | -16% |
| Centra | $33,400 | $43,041 | $38,064 | -69% | -19% | -30% | -39% |
| Interwoven | $126,832 | $111,512 | $160,388 | -121% | -45% | -15% | -60% |
| **Network Tools** | | | | -3% | 6% | 15% | 6.0% |
| Citrix Systems | $588,625 | $741,157 | $908,722 | 26% | 21% | 23% | 23% |
| McAfee (Network Associates) | $936,336 | $910,542 | $987,299 | 7% | 35% | 16% | 19% |
| Tarantella | $14,220 | $14,006 | $12,488 | -104% | -66% | -128% | -99% |
| Novell | $1,105,496 | $1,165,917 | $1,197,696 | -3% | 6% | 36% | 13% |
| Altiris | $62,876 | $99,339 | $166,565 | -1% | 13% | 15% | 9% |
| Tumbleweed | $25,525 | $30,595 | $43,438 | -78% | -32% | -18% | -43% |
| NetManage | $65,740 | $50,663 | $47,666 | -26% | -9% | -3% | -13% |
| **Developer Tools** | | | | 8% | 13% | 11% | 10.6% |
| Raining Data | $21,006 | $22,297 | $21,483 | 0% | -1% | 1% | 0% |
| Pervasive Software | $39,205 | $49,608 | $48,352 | 17% | 16% | 8% | 14% |
| Progress Software | $309,060 | $362,662 | $405,376 | 12% | 13% | 16% | 13% |
| Borland Software | $244,579 | $295,236 | $309,548 | 8% | -14% | 6% | 0% |
| Sybase | $829,861 | $778,062 | $788,536 | 7% | 13% | 11% | 11% |
| Red Hat | $90,275 | $124,737 | $196,466 | -19% | 2% | 14% | -1% |
| BEA Systems | $934,058 | $1,012,492 | $1,080,094 | 14% | 17% | 18% | 17% |
| **Education** | | | | -3% | 10% | -7% | -0.1% |
| Renaissance Learning | $131,232 | $130,544 | $114,048 | 36% | 37% | 30% | 34% |
| Apollo Group | $1,339,517 | $1,798,423 | $2,251,472 | 29% | 24% | 32% | 28% |
| Saba Software | $44,416 | $34,471 | $42,210 | -39% | 36% | -7% | -4% |
| American Education Corp. | $8,483 | $8,599 | $10,400 | -9% | 6% | -8% | -4% |
| Scientific Learning | $29,916 | $30,976 | $40,319 | 4% | 10% | -2% | 4% |
| Plato Learning | $82,192 | $141,801 | $121,804 | -3% | 0% | -23% | -8% |
| SumTotalSystems | $30,477 | $29,487 | $55,204 | -52% | -20% | -29% | -33% |
| **All companies (median)** | $133,316 | $137,159 | $181,516 | **-0.3%** | **5.7%** | **8.9%** | **4.8%** |

Note: "'Years" may not correspond to company fiscal years.

**this was grossly unfair.**

This attitude of "unfairness" arises from a misunderstanding of what a patent is. It's basically an exclusionary right; "injunctions" are really all a patent provides the patent holder. It's no surprise a judge will be inclined to grant injunctions in patent cases. And it's nothing new for a court to grant an injunction and throw a company out a business when it's been determined it's infringed. Remember the Kodak vs Polaroid imbroglio? The court threw Kodak out of that market at a cost to the company of almost $1 billion dollars.

> "Lawsuits are sophisticated warfare. There will always be four to six opportunities to settle during a case. Be prepared to work out a strategy to settle and gain an advantage."
>
> —*Rory J. Radding*
> *Morrison & Foerster LLP*

Now, there are a very few exceptions where the inclination of the court can change. For instance, the University of Wisconsin owned a patent on the production of vitamin D but the court refused to grant an injunction because of public health concerns. I do think there should be more exceptions but in patent law, injunctions are more the rule than the exception and will continue to be. Another factor to remember is that while high-tech wants to see injunctions weakened, bio-tech wants to see them stay strong. Some universities also have strong patent licensing programs; Columbia, for example, has a huge IP licensing program. Is Columbia a "patent troll?"

**Do you think business method patents will continue to be with us?**

Courts are not going to eliminate BM patents. This type of patent when combined with software is not really new; in the 1980s, Merrill Lynch received a patent on their CMA (cash management account) process and those patents were upheld. Later, the State Street case helped codify something the courts had already held patentable. Now, there are a lot of garbage patents out there; during the Internet bubble many patents got through the Patent Office that shouldn't have. But there's a place for BM patents and they're going to stay with us.

**There's been several predictions made that the RIM vs NTP will lead to major changes in patent law. What is your opinion?**

As soon as Congress acts, the USPTO is going to be implementing a new system that will allow opposition proceedings to take place within the agency. This will shift some of the litigation away from the courts and be cheaper, though you'll still be able to go to the courts if you don't like the outcome. Over time, I think this will lead to better patents.

**Are there international repercussions from the case?**

Yes. The NTP case gives hope to an owner of a US patent that your patent will be enforced even if you're dealing with an international company. It also established that a company like RIM couldn't avoid infringement even though some of the patented processes were executed outside the US.

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# Earnouts: The Good, the Bad, and the Ugly

*By Marshall Warwuruk*

An earnout is a technique used to help close the valuation gap that often arises between buyers and sellers by making a portion of the purchase price contingent upon achieving specified objectives. For the most part, earnouts are used in smaller transactions involving private entities and, to a much lesser extent, larger and/or public traded companies. Today, close to 40% of all deals involve earnouts, can make up as little as 20% of the total consideration, and can potentially double the size of deal.

From the buyer's perspective, the upside of earnouts is that it helps reduce the financial risk by protecting buyers from overpaying while providing incentives that focus management on achieving specific goals, like meeting revenue and profit projections originally prepared by the seller. The downside is that it reduces the buyer's ability to completely integrate or restructure the business; they also create divided loyalties and conflicting objectives—the strategic direction of the business versus the earnout prejudice of the acquired entity.

Sellers beware. While the upside is more cash, you need to take into consideration the implications of the loss of control over the operating budget and staffing plans. These often put you at risk for achieving the stated objectives and the likelihood of a reduced payout. Furthermore, changes are inevitable as buyers tend to subordinate most of the seller's decision-making authority, as strategic direction and corporate policies, like compliance with Sarbanes Oxley and financial controls, take precedence.

There is also the ugly side of earnouts when disputes and threatened litigation arise over contingency payments. Changes to the post-acquisition plan and direction of the acquired entity, as well as revenue recognition policies that diminish the payout, or artificially depress revenues during the earnout period, are often at the center of these disputes. And, more than money is lost in the case of an earnout disagreement as the business suffers the affects of poor employee morale and turnover. In the end, neither party wins. However, handled with care, earnouts can be a good practice when both parties are keenly aware of the risks and downsides to the earnout aspect of deal making.

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| Company/Description | Acquired by | Price/Terms | Revenues | Multiple |
|---|---|---|---|---|
| **I-Logix** <br> • *Modeling tools* | Telelogic AB (TGIAF.PK) | $80,000,000 <br> *Terms: All cash* | $26,800,000 | **2.99** |
| **Unify (UNFY.OB)** <br> • *Business automation solutions* | HALO Technology Holdings | $21,000,000 <br> *Terms: All stock* | $10,580,000 | **1.98** |
| **SBS Technologies (SBSE)** <br> • *Embedded software* | GE Fanuc | $215,000,000 <br> *Terms: All cash* | $146,700,000 | **1.47** |
| **Visma (Norway)** <br> • *Business management software* | Sage Group (SGGEF.PK) | $583,000,000 <br> *Terms: All cash* | $289,100,000 | **2.02** |

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MERGERS & ACQUISITIONS

## New and Interesting Reads

- *MicroISV: From Vision to Reality* by Bob Walsh, Apress, 2006. This is a very useful book for the small software company and/or entrepreneur interested in launching their own software startup. Coverage of topics such as setting up a payment system for your website, listing your product with various download sites, incorporating, website setup, etc., is good and much useful advice is provided. However, if your business model calls for such activities as placing advertising, direct mail, managing a telesales force, and so on, MicroISV provides little information on these topics; its emphasis is heavily oriented towards Internet activities. For the small company, a must read.

- *The White Paper Marketing Handbook* by Robert W. Bly, Thomson, 2006. A highly specialized and very useful book for any software marcom group. Covers all aspects of creating white papers, including types, formatting issues, structure, layout, and distribution. One criticism is a direct mail section that seems to have been tacked on at the end; it's out of place and the pages could have been used for more useful purposes, such as an analysis of an actual white paper for its adherence to the points discussed in the book.

**IT ARCHITECT COLUMNIST GARY MCGRAW ON WINDOWS SECURITY FLAWS:** "Even though Microsoft has spent hundreds of millions of dollars on software security, company representatives still expressed great surprise when the Windows Metafile (WMF) vulnerability surfaced. There's a simple reason for this. Microsoft's approach, commendable in many ways, involves an overemphasis on code-level bugs and is thus subject to a major blind spot: overlooking architectural flaws such as the WMF problem." (Quoted in *IT Architect*, 03/02/2006)

**ZDNET BLOGGER DION HINCHCLIFFE ON SAAS ADOPTION PATTERNS:** "Does SaaS offer enough reliability, security, scalability, and in the end, trust for companies to bet their businesses on? The answer for many right now will be no. And so early adoption will be left to extremely tactical and non-critical functions like corporate blogging and wikis." (Quoted on http://blogs.zdnet.com/Hinchcliffe/index.php?p=17&tag=nl.e539, 02/24/2006)

**GOLDMAN SACHS ANALYST RICHARD SHERLUND ON MICROSOFT AND SAAS**: "Microsoft seems to be adapting to the new market dynamics in a way that could be complementary to its traditional business. The Web will be an extension of the desktop in a way that becomes more seamless, extending the capabilities of the desktop outward." (Quoted in *The New York Times*, 03/21/2006)

**VANITY FAIR COLUMNIST MICHAEL WOLF ON STEVE JOBS:** "Except that one day in the near recent past everybody woke up and found out that while all the geniuses were blathering on about content this and content that, the media culture had, in fact, come to be dominated by machines. It's Steve's gadget-centric world which we just live in." (Quoted on http://www.vanityfair.com/commentary/content/printables/060320roco01?print=true, 03/27/2006)