Comments
Relating to

PUBLIC HEARINGS CONCERNING THE EVOLVING INTELLECTUAL PROPERTY MARKETPLACE

Submitted By

THE SOFTWARE & INFORMATION INDUSTRY ASSOCIATION

to

THE FEDERAL TRADE COMISSION

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The Software & Information Industry Association ("SIIA") is the U.S. trade association of the software and digital content industries. SIIA is the nation's oldest and largest association representing software and content companies. SIIA has grappled with important intellectual property issues in the software and content industries for many years. Its members range from start-up firms to some of the largest and most recognizable corporations in the world. SIIA member companies[1] are leading providers of, among other things:

- software publishing, graphics, and photo editing tools
- corporate database and data processing software
- financial trading and investing services, news, and commodities
- exchanges
- online legal information and legal research tools
- protection against software viruses and other threats
- education software and online education services
- open source software
- and many other products and services in the digital content industries.

[1] A list of the more than 500 SIIA member companies may be found at: http://www.siia.net/membership/memberlist.asp.

The innovative companies that make up SIIA's membership rely upon patent protection to guard their inventions, but also depend upon the ability to manufacture, develop, and sell their products free from improper assertions of patent rights. Consequently, SIIA's members are involved in patent litigation as both patentees and accused infringers; they cannot be categorized as generally plaintiffs or generally defendants.

SIIA members have benefited from owning thousands of patents. Yet they also rely critically on the boundaries to patent protection, as these boundaries, too, preserve their ability to innovate. As such, SIIA's collective membership sits at the crossroads of the countervailing interests in the ongoing debate on patent reform and the evolving IP marketplace. SIIA is therefore in a position to offer a balanced view on the issues raised by the FTC, informed by the business realities of the industries most affected by them.

1. How has the IP marketplace changed in the past five to ten years? What changes are expected in the future? What aspects of the patent system drive those changes? What is the impact of those changes on innovation?

One of the most significant change to the patent marketplace[2] that has occurred in the past five to ten years has been the increased frequency and affect of Non-Practicing Patent Tranferees[3] ("NPPT") on businesses, primarily those businesses specializing in technology and creating jobs in the knowledge-based economy. NPPTs typically do not innovate. The business model of a typical NPPT is to obtain the patent rights from others for the purpose of licensing those rights. They do not develop new inventions for others to learn from or take advantage of, as they have no assets other than the patents that they hold. Nor do they manufacture or disseminate patented inventions for the public to use.

In the area of patent enforcement, NPPTs often have a distinct advantage over others – an advantage they seek to leverage to obtain large settlement amounts or licensing fees. There are several reasons NPPTs are able to create such an uneven playing field. First, they amass large patent portfolios that, *regardless of relevance or quality*, are financially impractical for most companies to defend against in litigation. Second, because NPPTs do not produce products or services themselves, they are immune from patent infringement counterclaims by a defendant company -- a practice that under normal circumstances would serve to stabilize disputes between parties in a patent suit. Third, NPPTs have access to significant funding dedicated to acquiring patents and enforcing those patents. By contrast, litigation costs (as well as steps taken to reduce the threat of litigation) significantly reduce their targets' resources for research and development and product offering and creation. Fourth, NPPTs are typically privately held, with no obligation to disclose assets, finances, and strategies (in contrast to defendant

[2] Although this question and the questions that follow relate to "intellectual property" (IP), because it is clear that the primary, if not sole, focus of the FTC hearings and these questions relate to the patent marketplace, we have restricted our responses accordingly. To the extent the FTC seeks comments on other forms of intellectual property, such as copyrights or trademarks, we reserve the right to amend these comments.

[3] These entities are often referred to by the unfortunate and loaded term "patent trolls." We use the term NPPT

companies). This makes it impossible to know if, where, when, or how they will approach a target, whereas many of their targets are publicly held, and thus required to disclose products, strategies, finances. Consequently, NPPTs simply wait for their targets to be successful, and then approach the successful target for investment/funding/licensing requests. There is little the target can do to prevent this *regardless of the relevance or quality of the NPPT patent portfolio.* All these factors weigh heavily in favor of an NPPT and against the target of their actions, which in turn forces settlement terms that are extremely beneficial and profitable to the NPPT.

Taking into account this set of circumstances, as well as the rise in enforcement of patent rights by NPPTs, NPPT access to substantial funding, the large number of patents for sale and the questionable quality of many patents, the result is an environment that is conducive to abuse and one that is contrary to the operation and purpose of the patent system.

The impact on innovation and market competition of these changes is dramatic, reducing innovation and value creation, and diverting resources to non-productive activity and costs. By leveraging their advantaged position over their targets, NPPTs are able to extract licensing fees, "investments", and other forms of payment in the tens to hundreds of millions of dollars, in a few cases, aggregating billions of dollars from their targets. These fees could otherwise be used for innovation, job creation, new product offerings for consumer choice, and turning innovation into useful products and services that others in turn can innovate upon. With the downturn of the U.S. economy and so many technology and other companies struggling to stay competitive, the NPPT problem is causing a huge drag on the patent marketplace.

2. What are the new business models involving intellectual property? What has motivated the development of these business models? What is their impact on innovation?

There are a number of new NPPT business models involving patents.

In some models, traditional investing entities (*i.e.*, hedge funds, financial institutions, endowments, universities) invest in "Predatory NPPTs" (an NPPT that amasses a patent portfolio for the purpose of motivating investment or licensing via threat of enforcement against intended targets) with an expectation of a return on investment that at least rivals traditional, productive investments. In other models, a Predatory NPPT requires its target to "invest," or purchase a license, in exchange for a broad patent license. In some cases, the Predatory NPPT offers the target a potential for return on investment. In each case, the Predatory NPPT uses the investment/license funds to purchase additional patent assets to attract further investment or create a more formidable licensing engine.

A target that does not want or cannot afford to invest or pay a licensing fee runs the very real and significant risk of inviting a patent infringement suit by the Predatory NPPT, who is in a vastly superior position from the outset (see response to Question 1, above). Predatory NPPT investment/license fees tend to be in the tens and (sometimes) hundreds of millions of dollars, depending on the size of the target.

More recent business models have been developed to "protect" targets from Predatory NPPTs. In "Patent Trusts," companies join a patent management organization, make some form of a recurring payment, or maintain a particular capital commitment level in an account with the Trust. In exchange for participation, the Trust acquires patents that may otherwise be purchased by a Predatory NPPT, providing a license to its members.

Once licensed to a member, the business model of the Trust typically provides for the eventual resale of the patent asset into the patent marketplace. Because the Trust does not rely on threat of enforcement for licensing revenue, it has no need to maintain a patent portfolio. The Trust's fees tend to be relatively low compared to Predatory NPPT models, typically either in the low tens of millions, and more typically less than ten million per year.

The impact of both models, the Predatory NPPT and the Trust are similar. Resources that are used to invest in the NPPT or Trust are resources that will not be used for innovation to foster competition, creation of new products or services, hiring employees, or enhancing and benefiting consumer choice in goods and services. Moreover, these costs are ultimately passed onto the consumer in the form of higher prices, creating a non-productive drain on the nation's critical economic resources needed for investment, innovation and growth. The impact of such non-productivity is most dramatically felt in periods of financial downturn such as the present national economic times.

3. What economic evidence is relevant when analyzing whether to grant a permanent injunction following a finding of infringement? What proof have courts required? How should the analysis take into account the incentives to innovate provided by the patent system and the benefits of competition? What is the appropriate remedy when the court has denied a permanent injunction after a finding of infringement?

The grant of an injunction can have a ripple effect in the technology and other knowledge-based industries that causes companies to focus their energies on a design around the patented technology or to wait until the Federal Circuit decides the case and the metes and bounds of the patent claims.

When a technology business is developing a new device or a new computer program, it often is extraordinarily difficult – notwithstanding the business's best efforts – to identify all of the existing patents, and pending patent applications, that may be relevant to each of the hundreds or even thousands of components that make up that new product.[4] Technology industries are characterized by what are termed "patent thickets" – "dense web[s] of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology."[5]

[4] FTC Report, Ch. 2, at 28.

[5] Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard Setting*, in 1 INNOVATION POLICY AND THE ECONOMY 119, 120 (Adam B. Jaffe et al. eds., 2000).

With this myriad of often-overlapping patents, no technology business can review every potentially relevant patent before designing and commercializing a new product. As a result, the firm may invest substantial time and resources in a new product before becoming aware that an arguably patented technology is embedded somewhere within its design. This is especially true because the grant of a patent may lag behind the introduction of a product by many years, and may not be brought to the attention of the industry until many years after that.

Moreover, patent infringement claims are easy to assert, but difficult to disprove. Especially in the technology context, the validity of a patent – as well as its legitimate boundaries – sometimes may be difficult to determine. This allows the assertion of extremely tenuous claims (whether in a demand for a license, or lawsuit) (as discussed in more detail in the answer to question one).[6]

If a hardware or software company becomes aware of the possibility of a patent infringement claim *before* it designs a new product, it has the choice of designing around the allegedly patented technology or obtaining a license to use it. At that point, the cost of a license would reflect the relative difficulty of designing around the technology as well as the strength of the potential infringement claim. Stated simply, a strong patent that is difficult to design around can command a relatively high licensing fee, while a weak one that is easy to design around cannot. Of course, in some circumstances a technology company may not as a practical matter be able to design around a patent claim – such as when the claim would prevent the company from making new products compatible with existing ones, or with an industry standard that permits interaction with the products of other manufacturers.

The situation becomes dramatically different from a business perspective when an infringement claim is asserted *after* the company has already initiated production or invested substantial time and resources in research and development. At that point, backtracking to design around the now-integrated technology will almost certainly involve substantial expense, waste, and delay. Indeed, "redesigning a product after significant costs have been sunk is usually not economically viable."[7] As a result, there will be overwhelming pressure on the company to obtain a license of the patent that allegedly is being infringed.

An injunction standard that is too easily granted would then provide extraordinary, unfair leverage to the potential infringement plaintiff in this situation. When an injunction is always or virtually always available, the potential plaintiff can demand a licensing fee that reflects the technology company's sunk costs and the losses that an injunction would inflict, not just the ordinary market value of the license. This extreme bargaining inequality exists even if the patented technology is only an insignificant part of the product as a whole (see response to question 4 below). Even if the arguments with respect to infringement – or with respect to the

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[6] *See, e.g.*, James Bessen & Michael J. Meurer, *Lessons for Patent Policy from Empirical Research on Patent Litigation*, 9 Lewis & Clark L. Rev. 1, 16 (2004)

[7] FTC Report, Ch. 3, at 40.

validity of the patent – are weak, the downside risk to the technology company is so great that the company has little ability to withstand the potential plaintiff's demands. The threat of disruption of the technology company's business will be so significant that the incentives for the company to reach an agreement are overwhelming.

Recent court decisions, in particular the landmark decision in *eBay Inc. v. MercExchange LLC*,[8] have made a significant step in the right direction toward addressing this problem by putting an end to the presumption of irreparable harm and requiring courts to consider that traditional four-factor injunction standard.[9] Nevertheless, as outlined in our response to several of the other questions, we continue to believe that more can be done to curb the deleterious effect that injunctions is having on the software and knowledge-based industries.

4. Do the legal rules governing patent damages result in awards that appropriately compensate patentees? Are there circumstances in which they result in overcompensation or undercompensation of patentees? What evidence is there of the extent of these problems? What information would be helpful to better assess whether damage awards appropriately compensate patentees? Are courts and juries able to make damages determinations with sufficient accuracy? To the extent that there are problems resulting from the determination of damages for patent infringement, how should they be addressed?

Owners of technology patent are appropriately compensated when the value of their contribution is properly apportioned in relation to the value of the product or service in which the patented technology resides -- not the entire value of the product or service. Much economic literature, and significant cases, support this concept.[10] Nevertheless, courts have been inconsistent in applying it, leading to lost profit and royalty awards that sometimes are vastly disproportionate to the market value of the patented invention(s).

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[8] 547 U.S. 388 (2006)

[9] "That test requires a plaintiff to demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law are inadequate to compensate for that injury; (3) that considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction."

[10] *See, e.g., Georgia-Pacific Corp. v. U.S. Plywood Corp*. 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970) (oft-cited "Georgia Pacific" royalty factors include "[t]he portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer."); *Grain Processing Corp*. v. *American Maize-Products Co.*, 185 F.3d 1341, 1350-52 (Fed. Cir. 1999) (evaluating true economic contribution of the patent in relation to alternatives that could have been used in the product to substitute for the patented element); John W. Schlicher, *Measuring Patent Damages by the Market Value of Inventions - The Grain Processing, Rite-Hite, and Aro Rules*, 82 J Patent & Trademark Off Socy 503 (2000).

New technologies are often so complex that one product can relate to thousands of patents. The problem, however, is that patentees often seek a royalty that is a percentage of the value of the overall product -- even though the patentee's inventive contribution relates to an extremely small aspect of the product taken as a whole. For example, the patentee may seek a royalty of 10% of the overall price of a product, even if the patented product relates only to a minor and rarely used option.

Current law does a poor job of ensuring that a patentee receives a royalty in proportion to the actual value of the patented component in relation to the product that contains that component. Many damage experts rely on the traditional principle that licensors should receive a quarter to a third of the profit made on a product. However, if there are many other patents relevant to a particular technology, this type of solution is "patently" unfair. Changes in the law, either legislatively or though court decisions, are needed to level the playing field to ensure that appropriate apportionment of damages.

5. How have changes in willfulness doctrine changed the behavior of patentees and potential infringers? Do recent changes in the law adequately address the concerns with willfulness doctrine identified in the October 2003 FTC IP Report?

We recognize the importance of a meaningful standard of willfulness, as reflected in other areas of intellectual property law, to achieving the aims of effective deterrence to infringement of patents. Yet, as the FTC observed in its 2003 report:

> It is troubling that some businesses refrain from reading their competitors' patents because they fear the imposition of treble damages for willful infringement. Nonetheless, infringers must not be allowed to profit from knowingly and deliberately using another's patented invention due to a low likelihood that the patent holder can afford to bring suit or obtain substantial damages. The FTC's recommendation would permit firms to read patents for their disclosure value and to survey the patent landscape to assess potential infringement issues, yet retain a viable willfulness doctrine that protects both wronged patentees and competition.[11]

While recent court decisions (discussed below) have altered the standard for willfulness, it is our view that one of the areas worth attention as part of patent reform remains treble damages based on claims of willfulness. Too often, NPPTs use the threat of treble damages to attempt to extract a greater settlement than may be economically justified, and they appear to be adjusting their conduct in negotiations before a case is filed, and outside the context of litigation procedure, in light of these developments.

[11] FTC Report, pg. 20

To some extent the problems with the willfulness standard have been addressed by recent cases. . For instance, in *In re Seagate,*[12] the court held the patent owner plaintiff must prove "by clear and convincing evidence that the infringer acted despite an objectively high likelihood that its actions constituted infringement of a valid patent. [Citation omitted.] The state of mind of the accused infringer is not relevant to this objective inquiry." The court also held that the patent owner plaintiff must prove that "this objectively-defined risk (determined by the record developed in the infringement proceeding) was either known or so obvious that it should have been known to the accused infringer." In so ruling, the *Seagate* court rejected a negligence standard as a basis for willfulness. Just as significantly, the court addressed the potential choices defendant companies face with disclosing attorney work product, concluding that "fairness counsels against disclosing trial counsel's communications on an entire subject matter in response to an accused infringer's reliance on opinion counsel's opinion to refute a willfulness allegation."

No clear trend has emerged from recent cases, following *Seagate,* to conclude that a clearer standard has emerged to give technology and knowledge-based companies the parameters of what constitutes willfulness through evidence of the defendant's conduct before the litigation. Thus, these companies still must treat the risk of treble damages as unreasonably high which, again, results in overpayment to NPPTs and other wasteful spending.

6. How will changes in patent law rendered by Supreme Court and Federal Circuit decisions of the past five years affect the value of patents? How will these changes affect the operation of the IP marketplace? How will they affect innovation and competition?

As noted in several of our answers, there have been many positive developments in recent court decisions, such as limiting when injunctions can be issued and limiting the standard for determining willfulness. These decisions have not so much as affected the value of patents as affected the way in which these patents can be enforced. Despite progress made through the courts to level the playing field, as noted earlier, further reform (through the courts or Congress) is needed to address the apportionment of damages problem (as well as other issues not raised in these questions).

7. How does uncertainty regarding the validity and scope of patents affect the operation of the IP marketplace? Does the current system adequately fulfill the notice function of patents? How does uncertainty influence the operation of the IP marketplace? What are the sources of uncertainty that affect the value of patents and the operation of the IP marketplace? What could be done to address them?

See response to question 8 below.

[12] 497 F.3d 1360 (Fed. Cir. 2007)

8. How transparent is the current IP marketplace? Can it be made more transparent? Is that desirable?

The issue of the validity, scope and transparency touch on a number of issues, many of which were detailed in the FTC's 2003 report. The analysis found in that report remains essentially sound today, when it stated that:

> The validity of patents emerging from the PTO often is subject to question and not resolved until the end of litigation. The scope of the patents, both in terms of their literal claims and the operation of the doctrine of equivalents, often is unclear. When unpublished applications and lengthy continuations are added to the mix, uncertainty is further magnified.[13]

Even as efforts have been made to address some of these issues through administrative steps taken by the PTO, the quality of patents issued, particularly in certain areas such as software and other knowledge-based industries, continues to generate uncertainty in the operation of the technology marketplace. That impact ranges from companies devoting significant resources for defensive litigation,[14] taking valuable research and development resources to find "workarounds," and otherwise committing valuable innovation time to working the process of patents. We concur with the more recent testimony of the FTC which outlined the ways in which patents of questionable quality can distort competition, innovation and the marketplace:[15]

- First, they may slow the follow-on innovation by discouraging firms from conducting research and development in areas that the patent improperly covers.
- Second, patents that should not have been granted raise costs when they are challenged in litigation.
- Third, questionable patents may raise costs by inducing unnecessary licensing.
- Fourth, firms facing patent thickets may spend resources obtaining "defensive patents," not to protect their own innovation from use by others, but to have "bargaining chips"

[13] FTC Report, pg. 214.

[14] *See* discussion above in questions 1-3. *See, also*, Testimony of Edward R. Reines, Silicon Valley Office Weil, Gotshal & Manges, LLP, before the House Committee on the Judiciary Subcommittee on Courts, the Internet, and Intellectual Property, Hearing on "*Patent Trolls: Fact or Fiction?"* June 15, 2006.

[15] Prepared Statement of the Federal Trade Commission Before the Subcommittee on Courts, the Internet, and Intellectual Property of the House Committee on the Judiciary, "*American Innovation at Risk: The Case for Patent Reform*," Suzanne Michel, Deputy Assistant Director for Policy and Coordination Bureau of Competition Washington, D.C. February 15, 2007.

to obtain access to others' patents through a cross-license, or to counter allegations of infringements.

In the view of SIIA, legislative reforms are needed to address many of the issues associated with this uncertainty, particularly the economic impact of litigation associated with the exercise of patents. We also believe that efforts, such as the Peer-to-Patent[16] initiative, which "will review up to 400 applications classified in any of U.S. classifications 380, 700, 703, 705 through 715, 717, 718, 719, or 726 (covering Computer Architecture, Software and Information Security, Business Methods and E-Commerce)" are constructive, industry steps that will contribute to better quality patents being issued by the PTO.

9. During the past five years, what new learning has furthered the understanding of the patent system and the IP marketplace?

The release of the FTC's report in 2003 heralded an important benchmark that permitted those who care deeply about a strong, functioning patent system to take stock of the strengths and challenges facing our nation's innovation system. The experience of the last five years, in fact, confirms many of the essential findings, conclusions, and recommendations of that report. While some adjustments have been made, most notably by recent decisions of the U.S. Supreme Court, the experience of the past five years confirms the need for Congressional action to address some of the most important issues raised by the FTC examination.

[16] http://www.peertopatent.org/