



February 5, 2009

Honorable Donald S. Clark
Secretary
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Room H-135 (Annex I)
Washington, DC 20580

Re: Evolving IP Marketplace – Comment, Project No. P093900

Dear Mr. Clark:

The Coalition for Patent Fairness (“CPF”) and the Business Software Alliance (“BSA”) are pleased to submit these comments in connection with the Commission’s study of the Evolving Intellectual Property Marketplace.¹ Our comments focus on several of the questions posed in the Commission’s request for comment:

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

¹ The Coalition for Patent Fairness is a diverse group of companies and industry associations dedicated to enhancing U.S. innovation, job creation, and competitiveness in the global market by modernizing and strengthening our nation’s patent system. See www.patentfairness.org. The Business Software Alliance is an association of the world’s leading software and hardware technology companies. BSA members collectively own more than 30,000 patents, and include three of the six leading patent recipients for 2006. Because patent policy is vitally important to promoting the innovation that has kept the United States at the forefront of software and hardware development, BSA members have a strong stake in the proper functioning of the U.S. patent system.

- 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?
- 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?²

CPF and BSA have a unique perspective on these issues. Intellectual property plays an important role at our member companies; indeed, our members include companies that routinely appear on the Patent and Trademark Office’s list of the top U.S. recipients of patents. At the same time, member companies are victims of a substantial amount of unjustified patent litigation. CPF and BSA are therefore well positioned to provide comments that describe the flaws in the current litigation system, but also recognize the importance to the U.S. economy of vigorous protection of intellectual property.

Introduction and Summary

The Commission’s pathbreaking 2003 study, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy* (October 2003) (“FTC IP Report”), recognized the onset of several key trends that have continued for the past six years. Thus, the Commission observed that—with respect to computer hardware and software—witnesses indicated that “patent thickets divert funds away from R&D, make it difficult to commercialize new products, and raise uncertainty and investment risks.”³

Recognizing the effect on innovation, the Commission stated that “[s]ometimes, follow-on innovation and production depends on having access to patents that are economically infeasible to license because they are too numerous to license individually or even to learn about.”⁴ It continued: “Unless downstream actors – whether innovators or manufacturers – can mitigate the problem, they may have to choose between the risk of being sued for infringement after they sink costs into invention or production, or dropping innovative or productive efforts altogether. *Either option can injure economic welfare.*”⁵ Finally, the Commission cited the comment of one panelist who “hypothesized that NPEs’ [non-practicing entities] invulnerability may create a competitive problem if it prevents the type of cross-licensing that has evolved as a ‘safety valve’ due to the prevalence of overlapping and cumulative patents.”⁶

NPE activity in the technology sector—in terms of acquisition of patents, licensing demands, and litigation—has exploded since the Commission’s 2003 report. This tremendous growth in NPE

² CPF and BSA also have a strong interest in the issues raised by the Commission’s other questions, but have chosen to focus these comments on the extremely pressing issues of marketplace changes and damages calculation in patent litigation.

³ FTC IP Report, ch. 3, at 2.

⁴ FTC IP Report, ch. 2, at 28.

⁵ *Id.* (emphasis added).

⁶ *Id.* at 31.

activity has produced the precise adverse effects predicted in the Commission's 2003 report. Infringement litigation—and the threat of such litigation—is imposing an increasingly substantial burden on companies attempting to bring new products to market. The result is a very significant increase in business risk, and a substantial diversion of resources away from innovation and into litigation and licensing expenditures. In addition, some product development has been abandoned because of potential litigation-related costs. Patent reform, and especially legislative clarification of the reasonable royalty standard, is necessary to eliminate these adverse effects—especially at this time, when we must do everything we can to encourage economic growth and job creation to help jumpstart our weakened economy.

Fundamental Change in the IP Marketplace: The Explosion in NPE Activity

Important trends recognized by the Commission in 2003 have continued—and even accelerated—during the ensuing six years.

First, an increasing number of technology products resemble microchips, computers and software programs in that they are made up of thousands of component parts, which themselves may implicate tens or hundreds or thousands of patents. As the Senate Judiciary Committee recently explained, “[l]ong past is the day in which the typical invention is a sui generis creation; today’s patents are often combinations, and many products comprise dozens, if not hundreds or even thousands of patents, and the infringed patent may well be one smaller part of a much larger whole.”⁷

Second, a considerable portion of the value of corporations today rests on their intangible assets, including their intellectual property. Indeed, the percentage of a company’s value represented by intangibles has continued to increase in recent years.⁸

Third, these trends have combined with other factors to produce an extraordinarily dramatic change: the growth of NPEs, which do virtually no research or product development or commercialization but are simply in the business of acquiring patents and monetizing their investment through licensing revenues. The growth of NPEs represents by far the most significant change in the patent marketplace.

Publicly-available information confirms the tremendous growth in NPE activity, just in the technology sector (NPEs are active in other sectors as well). To begin with, NPEs have raised billions of dollars in capital for use in acquiring patents. Thus, media reports indicate that a handful of NPEs have raised \$3.5 billion and are seeking nearly to double their resources through new investment.⁹

⁷ S. Rep. 110-259, at 12 (2008).

⁸ Malackowski & Barney, “Patent Attribution to Equity Returns,” available at www.oceantomo.com/PDFs/Patent_Attribution_to_Equity_Returns_1-6-09.pdf (68% in 12995; 80% in 2005).

⁹ Patent Pirates,” http://www.forbes.com/free_forbes/2007/0507/044.html; “Tech Guru Riles the Industry By Seeking Huge Patent Fees,” Wall Street Journal (Sept. 17, 2008); <http://richard-wilson.blogspot.com/2008/02/litigation-funding-from-hedge-funds.html>.

These multi-billion dollar resources have been used for the acquisition of many thousands of patents. One study found that 24 NPEs hold more than 16,000 patents, virtually all in the technology area.¹⁰

The NPEs' business model is to provide returns to their investors by obtaining license payments for the patents they purchase. As Justice Kennedy explained in the *eBay* decision, “[i]n cases now arising . . . the nature of the patent being enforced and the economic function of the patent holder present considerations quite unlike earlier cases. ***An industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees.***”¹¹

One recent study of this phenomenon observed that “[s]ome of the largest of these NPEs raise large funds with which to purchase the patents they seek to enforce—without any plans to turn those patents into marketable products or services. Instead, they then use these funds to enable—through direct or veiled threats of infringement—their pursuit of royalties from successful businesses.”¹² One NPE claims to have obtained \$1 billion in license payments.¹³

The recent Center for American Progress report on the patent system recognized that the problems of the system have been “exacerbated by the emergence of so-called non-practicing entities, or NPEs, sometimes called patent ‘trolls.’ Unlike operating companies that produce products and services, and universities that generate most of their revenue from tuition and grants and generate intellectual property through academic investigations, patent-holding entities typically do not produce any products or offer any service beyond patent licensing and enforcement. Their primary revenue sources are royalties obtained from asserting patents against successful product and service companies.”¹⁴

The NPEs’ Dramatic Effect on Patent Litigation and the Resulting Harm to Innovation and Economic Growth

Significant Changes in Patent Litigation. The result of the marketplace changes just discussed has been a dramatic change in patent litigation—there is more litigation, and that litigation is more costly, than ever before. “[I]n recent years, the cost and uncertainty of patent litigation has escalated, leading many to believe that it is an unbearable drag on the innovation that the patent system is supposed to foster.”¹⁵

First, in the past seven years, the number of defendants sued annually has nearly doubled (from 5,000 in 2000 to 9,000 in 2007),¹⁶ even though the number of lawsuits has not changed dramatically (remaining in the 3,000-3,500 range).¹⁷

¹⁰ <https://www.patentfreedom.com/research-phl.html>.

¹¹ *eBay Inc. v. MercExchange LLC*, 126 S.Ct. 1837, 1842 (2006) (Kennedy, J., concurring) (emphasis added).

¹² McCurdy, “Patent Trolls Erode the Foundation of the U.S. Patent System,” available at www.scienceprogress.org/2009/01/patent-trolls-erode-patent-system.

¹³ “Tech Guru Riles the Industry By Seeking Huge Patent Fees,” *Wall Street Journal* (Sept. 17, 2008).

¹⁴ Center for American Progress, “Tackling the Challenge of Patent Reform.”

¹⁵ S. Rep. 110-259, at 3 (2008).

¹⁶ <http://lexmachina.stanford.edu/static/html/Statistics.html>.

¹⁷ PricewaterhouseCoopers, “2008 Patent Litigation Study,” at 1.

Indeed, it is not unusual for a single suit to name a dozen or more companies. A plaintiff recently sued twenty separate financial institutions in a single action, claiming that its patent on a point of sale debiting system was infringed by the institutions' various payment services.¹⁸ That case is not at all unusual.¹⁹

Second, patent litigation is extremely expensive. One survey found that where more than \$25 million is at stake, which is the case for a large proportion of patent cases, the median litigation cost *per party* is \$5 million.²⁰ In large, complex cases, the defendant's discovery expenses alone can amount to many millions of dollars.²¹ The increase in the number of parties sued has thus greatly expanded the cost burden.

Third, there is a much greater risk of very large damages awards in patent litigation. Prior to 1990 there had been only one patent damages award in history larger than \$100 million;²² in the past seven years, there have been at least fifteen judgments and settlements in that category, and at least five that topped \$500 million.²³

The risk of high awards is especially great in the technology sector. Two-thirds of the damages awards exceeding \$100 million in 2005-2007 involved technology products.²⁴ In addition, the median damages award is much greater in technology-related sectors (telecommunications, software, office equipment) than in other sectors.²⁵

Fourth, there is considerable evidence that, as the House Judiciary Committee concluded, "current litigation practices often produce a royalty award substantially in excess of a reasonable royalty."²⁶ The Committee explained the problem in the context of technology products with numerous patented components:

Infringement suits typically focus on one or a few patents in isolation, rather than their relative contribution to an overall product. In economic theory, each patentee seeks to capture a share of the licensee (or infringer's) surplus. When the user has to pay monopoly rents for each of many patents (called 'royalty stacking'), the sum of the parts can become greater than the whole. In other words, the net total damage award can be

¹⁸ "J.P. Morgan, Citi Zinged Over Check-Reading Patent," IP Law 360 (Nov. 30, 2008).

¹⁹ See "Leon Stambler Stumbled But Has Not Given Up: A Brief Overview of Leon Stambler's Patent Enforcement Battles," Intellectual Property Today, available at <http://www.iptoday.com/articles/2009-1-bednarek.asp> (describing lawsuit filed in May 2008 against 18 financial institutions); .

²⁰ AIPLA Report of the Economic Survey 2007, at 25-26.

²¹ *Patent Troubles: Does the Patent System Need Fixing?* Corporate Legal Times, at 61, (June 2005).

²² William O. Kerr & Gauri Prakash-Canjels, *Patent Damages and Royalty Awards: The Convergence of Economics and Law*, in LES NOUVELLES at 83 (June 2003).

²³ Search of combined ALM VerdictSearch Jury Verdicts & Settlements database on Westlaw and PricewaterhouseCoopers, "2008 Patent Litigation Study." Another database reports even more huge cases: over the next ten years (from 1990 through 1999) there were 13 judgments and settlements in that category, and in the next six years (between 2000 and 2005) there were 21, including one award for \$1.35 billion. Internet Patent News Service & Source Translation and Optimization Co., Table of Patent/copyright infringement lawsuits/licensing awards, at <http://www.iplaw-quality.com/economic/awards.htm>.

²⁴ PricewaterhouseCoopers, "2008 Patent Litigation Study" at xx.

²⁵ *Id.* at xx.

²⁶ H.R. Rep. 110-314, at 26.

disproportionate to the patent's market utility. In some cases, it can exceed the infringer's total profit.²⁷

The Committee went on to explain the defects in current standards for calculating a reasonable royalty. The “constructed ‘hypothetical negotiation’” standard “can result in excessive royalties where the patent is used to block development or marketing of defendant’s products” because “a holdout patentee can extract above-market fees from potential licensees.”²⁸ The second approach, “using the defendant’s profits as a base for reasonable royalty, can also lead to excessive damages due to the difficulty in calculating what portion of defendant’s profits resulted from ‘the use made of the invention by the infringer.’”²⁹ The Senate Judiciary Committee elaborated on this point, observing that

The infringed patent may well be one smaller part of a much larger whole. Once infringement is proven, the patent holder is entitled to compensation for the use of the invention. But if juries award damages based on the value of the entire product, and not simply on the infringement—a danger exacerbated in some cases by overly expansive claim drafting—then damages awards will be disproportionate to the harm.³⁰

Adverse Effects Extend Far Beyond the Disputes Brought to Court. The economic burden imposed on innovation and economic growth due to these changes in the litigation system cannot be measured simply by looking to the disputes that result in litigation. As the Senate Judiciary Committee observed, high litigation costs and uncertain litigation outcomes “can encourage unreasonable posturing during licensing negotiations, as well as premature settlements simply to avoid the high cost and uncertainty of patent litigation.”³¹ The House Judiciary Committee reached the same conclusion: “A patent holder’s fee demand for a license increases as damage awards escalate. Awards, in turn, reflect inflation in license fees. This results in an upward cycle of ever increasing royalties, both those negotiated in the market and those awarded by juries.”³²

The House Committee endorsed Professor John Thomas’s analysis of the “adverse practical consequences” resulting from the trend of increasing damages awards:

“excessive awards may promote patent litigation. A rational patent proprietor may be unwilling to make fair royalty demands in the boardroom when they are able to obtain significantly higher damages awards in the courtroom;”

“the gap between the damages awarded for patent infringement and the marketplace value of a patented invention may also encourage speculation in patents;”

“high damages awards ‘may cause the scope of patent protection routinely to extend beyond the scope of its claims.’”³³

²⁷ *Id.* at 26 (footnotes omitted).

²⁸ *Id.*

²⁹ *Id.* at 26-27 (footnote omitted).

³⁰ S. Rep. 110-259, at 12 (2008).

³¹ *Id.* at 4.

³² H.R. Rep. 110-314, at 25-26.

³³ *Id.* at 26 (citation omitted).

For these reasons, the data on the number of actual suits filed and litigated reveals only a small part of NPEs' disruptive effects on the economy. These entities file suits only after repeated implicit threats are ignored or rejected, and offers for licensing are refused. Too often, the targeted companies pay off these demands, even when the merits of the claims are marginal. The reason is simple. Companies know that a patent suit will cost upwards of \$5 million to defend, not including the time of employees and the distraction from the business. They therefore pay the fee rather than incur these (typically higher) costs.

In fact, NPEs often target small and financially weak companies and offer them low licensing fees, knowing those companies will have little choice but to accede. They then use these settlements to leverage much larger settlements from other companies. One defense lawyer explained: “The strategy is to go after the small guys first. They just ask a small enough sum that it doesn't pay to fight. Not that it's always nickel and dime. Some of our clients have paid six-figure settlements. But it still beats litigating.”³⁴

The Litigation Changes, and Resulting Increased Burdens on Innovation and Growth, Flow From NPE Activity. The dramatic increase in litigation activity by NPEs—combined with the fact that the flaws in the reasonable royalty standard are peculiarly subject to exploitation by NPEs—have given the NPEs unprecedented economic power to hold innovation and economic growth hostage to payments of excessive licensing fees.

As a threshold matter, it is clear that the growth in litigation activity can be traced directly to NPEs. According to a recent report published by the Center For American Progress

- From October 1, 1994 through September 30, 2002, 527 patent lawsuits were filed by or against NPEs—about 2.7 percent of patent lawsuits filed in the United States during that 8-year period.
- In the four years from October 1, 2003 through September 30, 2007, there were 1,210 lawsuits filed by or against these entities, representing approximately 8.4 percent of all patent lawsuits, and exceeding 10 percent of all lawsuits in 2006 and 2007.³⁵

As the head of one NPE stated, “We are focused on obtaining jury verdicts.” He added, “[t]hat's why we put our own money at risk, all the way from acquisition through appeal.”³⁶

There is nothing inherently wrong with the patent licensing business model, and not every lawsuit filed by an NPE is abusive. But our fifty-year-old patent litigation statute was designed for an era of more conventional patent litigation, in which a patent owner engaged in manufacturing a product (or a patent owner that had granted an exclusive license to a manufacturer) sued a competitor that allegedly was infringing the patent by manufacturing a

³⁴ Steve Andersen, *IP Law Comes Of Age*, Corporate Legal Times, at 48 (Sept. 2004).

³⁵ McCurdy, “Patent Trolls Erode the Foundation of the U.S. Patent System,” available at www.scienceprogress.org/2009/01/patent-trolls-erode-patent-system.

³⁶ “Patent Pirates,” http://www.forbes.com/free_forbes/2007/0507/044.html.

competing product. The rules that deter such practicing entities from filing abusive lawsuits are not effective against NPEs.

In particular, as the Commission recognized in its 2003 report,³⁷ NPEs are not subject to the counter-threat of infringement claims asserted by defendants (because they do not practice any patents) and the “safety valve” of cross licensing is not applicable to NPEs because they neither manufacture a product nor provide a service and therefore do not need licenses in order to operate their businesses. “[B]ecause these NPEs do not derive any significant portion of their revenue from designing, developing, manufacturing, or selling products, they are essentially immune to counter-assertion claims by the companies from which they seek royalties. This profound disparity in NPE vs. product company assertions, as opposed to product company vs. product company assertions, has destabilized the patent system.”³⁸

This disparity is amplified by the asymmetric litigation costs borne by the product manufacturers that the NPEs sue. The NPE/plaintiff’s costs are minimal—information relating to the patent. *Each defendant*, on the other hand, must produce a huge volume of information relating to the development of the products at issue, the basis for customer demand for the product, etc. Given the high cost of electronic discovery, the burden on a defendant is very substantial. Moreover, the NPE has an incentive to spread its costs by suing as many defendants as possible. In that way, it need only exact settlements from a relatively small proportion of defendants in order to earn a profit on the litigation.

Under the current rules, therefore, an NPE has no incentive to focus its efforts on legitimate licensing demands and every incentive not to do so. The greater the number of patents with respect to which the NPE makes licensing demands, and the greater number of companies targeted with respect to each patent, the more “chances” the NPE has to obtain a licensing payment. And the incremental cost of each licensing demand is extremely low.

The same is true with respect to litigation. The NPE has an incentive to file a lawsuit with respect to the most marginal of claims. Its costs will be very low but the costs it inflicts on defendants will be substantial and the risk to each defendant of a huge jury verdict because of the vague reasonable royalty standard cannot be discounted. As a result, the possibility of settlement payments from at least few defendants is quite reasonable.

Indeed, one recent report indicated that “[c]ompanies defending against patent infringement charges are paying more money than ever to settle them early on, even when they view them as virtually meritless”; some of these settlements “exceeded the total sales volume of the product being challenged.” As one lawyer explained, “[a] technical patent case might get budgeted at \$2 or \$3 million dollars or more even if its completely lacking in merit, so there’s a lot of room to extract a settlement that has no relationship to the merits of the case or to the damages exposure.”³⁹

³⁷ FTC IP Report, ch. 2, at 31-32.

³⁸ McCurdy, “Patent Trolls Erode the Foundation of the U.S. Patent System,” available at www.scienceprogress.org/2009/01/patent-trolls-erode-patent-system.

³⁹ “Counting the True Cost of a Nuisance Settlement,” IPLaw360 (Oct. 27, 2008).

Initial settlements by some defendants are likely to stimulate settlement payments from others. And even if the NPE has to pursue the case to trial, its costs will be lower than those of the defendants and it has the potential of a huge award that will dramatically increase the future license fee-earning potential of the patents at issue.

Confirmatory Evidence of Litigation Abuse. The incentives provided by the current litigation rules are borne out in practice: there is substantial evidence of abusive litigation in this area:

- The growing disparity between damages awards by judges compared to juries: since 2001, the median award for jury trials has been more than ten times the median award by judges.⁴⁰
- The median damages award in the technology context—where products are made up of components representing hundreds if not tens of thousands of patents—is greater than the median award in industries in which the product embodies only a few patents.⁴¹
- The proliferation of cases in which claims sometimes assert that a patent license is necessary for production of equipment that satisfies a voluntary industry standard—even though the party asserting the infringement claim typically did not participate in the standard-setting process and asserts its interest only *after* the standard has been adopted. Often, these suits are based upon extraordinarily broad interpretations of the plaintiff's patent, and sometimes the patent claims alleged to have been infringed were filed years *after* the defendants released their products. These plaintiffs typically institute their infringement actions against large numbers of defendants.⁴² It is routine for these companies to send demand letters to fifty or 100 or more companies; one plaintiff sent such letters to **75,000** companies.⁴³

⁴⁰ PricewaterhouseCoopers, “2008 Patent Litigation Study” at 6.

⁴¹ *Id.* at 3.

⁴² At least sixty-two U.S. patent holders claim that wireless access to the Internet can be achieved under the “Wi-Fi” standard only by using their patented technology. IEEE Standards Association, 802.11 Patent Letters of Assurance, at http://standards.ieee.org/db/patents/pat802_11.html; Mark A. Lemley and Carl Shapiro, *Patent Holdup and Royalty Stacking*, at <http://faculty.haas.berkeley.edu/shapiro/stacking.pdf> (May 31, 2006), at 27. A number of those entities are sending demand letters and filing lawsuits asserting infringement claims. See, e.g., Nancy Gohring, *Hotspot Operators Face New Patent Fee Demand*, WNN Wifi Net News (Oct. 5, 2004) (available at <http://wifinetnews.com/archives/004184.html>); Peter Judge, *Wi-Fi world under threat from Symbol patent: Wireless vendor to seek license fees from all Wi-Fi equipment vendors*, Techworld.com (Sep. 23, 2004) (available at <http://tinyurl.com/gjt2s>). Similar claims have been advanced with respect to the RFID standard. “Wal-mart, Target Under RFID Patent Attack,” http://news.cnet.com/8301-10784_3-9876973-7.html. DataTreasury has targeted more than 70 financial institutions – including the nation’s largest banks and service providers – claiming that its patents cover federally-mandated remote check imaging processing and storage as well as other processes such as check clearing, electronic check processing, and electronic invoice processing. Several financial institutions already have entered into very large settlements. Glen Fest, *Patently Unaware*, Bank Technology News, at 28 (April 2006); Jennifer A. Kingson, *Two Patents, Many Lawsuits Aimed at Banks*, N.Y. Times, at C1 (Dec. 25, 2004).

⁴³ For example, RIM’s CEO testified that the plaintiff in the infringement action against it sent such letters to 47 companies. *Patent Quality Enhancement in the Information-Based Economy*: Hearings Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 109th Cong., (Apr. 4, 2006) (testimony of James Balsillie, Chairman and CEO, Research in Motion).

The consequences of these opportunistic lawsuits—the costs and other burdens (especially the time of engineers and others at the targeted companies) associated with the litigation plus costs and burdens from the many more licensing demands that never reach litigation—are severe. Hundreds of millions of dollars that otherwise would be devoted to research, development, and commercialization of new products and services are drained away into legal and expert fees as well as unjustified license and settlement payments. Rather than spending their time developing new products, hundreds of engineers must analyze opportunistic licensing requests and lawsuits. This huge diversion of resources means fewer jobs, fewer new products and services, and lower economic growth.⁴⁴

A narrow, focused change in the litigation rules is necessary to give NPEs appropriate incentives to focus their litigation efforts on legitimate claims. Indeed, President Obama’s technology agenda specifically recognizes the important role of the patent system in promoting innovation, and specifies as one of the President’s key goals reducing “uncertainty and wasteful litigation that is currently a significant drag on innovation.”⁴⁵

Clarifying Reasonable Royalty Standard Essential to Restore Balance to Patent Litigation

Patent law provides two potential measures of damages for plaintiffs who prove infringement. When the infringer is selling a product that competes with one sold by the patent owner, the patent owner typically will seek to recover lost profits based on the reduction in sales of the patent owner’s product. No one has identified any problem in the operation of the lost profits standard and no proposal for clarifying it has been advanced by any of the participants in the patent reform debate. We agree.

The second measure of damages is “not less than a reasonable royalty.” It is invoked by plaintiffs that do not sell goods or services and therefore cannot make a claim for lost profits. Because an increasing number of cases involve claims by NPEs, this measure has become predominant in patent litigation.⁴⁶ As the Senate Judiciary Committee recognized, “[j]uries are given little useful guidance in calculating that reasonable royalty,” and often are simply presented with a list of 15 factors “and then left to divine an appropriate award.”⁴⁷

Sometimes, the jury is told to guesstimate what the litigating parties would have agreed to had they negotiated before they went to court. The resulting confusion for juries is palpable. Struggling to find solutions, juries too often fall back on rules of thumb, 2 to 5 percent of the value of the \$1000 computer, the \$30,000 car or the \$100 million airplane. That 2 percent rule of thumb would yield damages of \$20 per computer when the invention at issue is little more

⁴⁴ Some NPEs have argued that the patent license fees they obtain spur the inventors who obtained those patents to engage in further innovation. But most NPEs “offer . . . trivial rewards to the inventor. . . . NPEs with hundreds of millions or billions of dollars in capital seek out patents held by others and pay the actual inventors a small portion of the money they seek to obtain in subsequent enforcement activities. It is hard to imagine that the prospect of netting so small an amount will, on its own, stimulate further innovation.” McCurdy, “Patent Trolls Erode the Foundation of the U.S. Patent System,” available at www.scienceprogress.org/2009/01/patent-trolls-erode-patent-system.

⁴⁵ <http://www.whitehouse.gov/agenda/technology/>.

⁴⁶ S. Rep. 110-259, at 11 & n.44 (2008).

⁴⁷ *Id.* at 11-12.

than a 25 cent power saver switch, of \$600 per car for an 85 cent radio volume button mounted on the steering wheel, or of \$2 million per airplane for a \$3 seat belt buckle.

“The time has come to give judges, and juries, better guidance on the proper way to calculate a reasonable royalty.”⁴⁸ By curbing the risk of excessive royalty awards, that change will provide NPEs with an incentive to focus their licensing efforts on legitimate claims.

That is why independent observers of the patent system support this reform, including:

- Professor John Thomas, Georgetown University Law Center: “[T]he case law and empirical evidence alike suggest that courts are inclined to award damages that far exceed an individual patent’s contribution to that particular product. . . . Damage awards that dramatically exceed the commercial patented invention lead to a number of deleterious practical consequences.”⁴⁹
- Professor Mark Lemley, Stanford Law School: “Because courts have interpreted the reasonable royalty provision to require the award of royalties based on the ‘entire market value,’ juries tend to award royalty rates that don’t take into account all of the other, unpatented components of the defendant’s product. This in turn encourages patent owners in those component industries to seek and obtain damages or settlements that far exceed the actual contribution of the patent. There are numerous cases of just this problem occurring. . . . There seems to be consensus that reasonable royalty damages should be limited to the share of a product’s value that comes from the invention and that patentees should not be able to capture value they did not in fact contribute.”⁵⁰
- Professor Adam Jaffee, Brandeis University: Citing as a key problem of current patent law “the availability of remedies or penalties for infringement that are far out of proportion to the economic harm that a patent holder may have suffered as a result of the infringement. While it is important that patent holders have the ability to uphold valid patents, remedies that are vastly disproportionate to the economic significance of the patent at issue do not serve any legitimate public policy purpose, and create the incentive and opportunity for those who would use the patent system for ransom and extortion rather than innovation.”⁵¹

Those who oppose clarification of the reasonable royalty standard argue that it will lead to

⁴⁸ S. Rep. 110-259, at 12 (2008). See also H.R. Rep. 110-314, at 27 (the “growing problem” of “excessive damage awards” can “be attributed to the lack of guidance provided to and by the courts in calculating reasonable royalty damages”).

⁴⁹ *Patent Reform Act of 2007*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 110th Cong., 1st Sess. 63 (2007).

⁵⁰ *Patent Quality Enhancement in the Information-Based Economy*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 109th Cong., 2d Sess. 38 (2006); see also Mark Lemley & Carl Shapiro, “Patent Holdup and Royalty Stacking,” 85 Tex. L. Rev. 1991 (2007); *Reply: Patent Holdup and Royalty Stacking*, 85 Tex. L. Rev. 2163 (2007).

⁵¹ *American Innovation at Risk: The Case for Patent Reform*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 110th Cong., 1st Sess. 14-15 (2007).

inadequate damages awards, which will in turn devalue intellectual property and deter innovation. But that argument, and especially the opponents' somewhat shrill predictions of cataclysmic consequences, is reminiscent of the public debate regarding the appropriate standard for injunctive relief in patent cases prior to the Supreme Court's unanimous decision in *eBay*.

One witness, addressing proposed legislation containing a multi-factor test similar to the one subsequently endorsed by the Supreme Court, said:

The proposal is a clean br[e]ak with over 200 years of respect for patents as property rights. . . . Whatever the possible abuses in the current law arising from the potential for an errant post-trial injunction to issue, the proposal to disable the right to enforce patent rights as property rights after a final, non-appealable adjudication of infringement is entirely unacceptable.⁵²

Others took a similar tone: "We believe the proposed changes in the law on availability of injunctions . . . would be a major blow to incentives for innovation provided by the American patent system and would result in a huge decline in the value of patents now in force. The role of the patent system in maintaining America's technological leadership would be diminished."⁵³

Indeed, even the amicus brief filed by the AIPLA in *eBay* sounded an apocalyptic note:

A dramatic change in this Court's precedent with respect to the availability of injunctive relief in patent cases would upset the well-established balance between the rights of the patentee and the public that has been critical to fostering the incentives to innovate that the patent system has successfully promoted since its inception.⁵⁴

But the Court rejected the AIPLA's position, and its decision has not brought about any of the predicted dire consequences. In the wake of *eBay*, courts are applying the general rule governing the availability of injunctive relief, sometimes granting injunctions and sometimes not depending upon the application of the traditional four-factor test for injunctive relief. For that reason, it simply is not possible to credit the renewed cries of impending disaster, this time tied to a modest clarification of the reasonable royalty standard.

⁵² *The Patent System Today and Tomorrow*: Hearing Before the Subcomm. on Intellectual Property of the Senate Comm. on the Judiciary, 109th Cong. (Apr. 25, 2005) (statement of Robert A. Armitage, Sr. Vice-President and General Counsel, Eli Lilly & Co.).

⁵³ *Committee Print Regarding Patent Quality Improvement*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 109th Cong. 12 (Apr. 20, 2005) (testimony of J. Jeffrey Hawley, President, Intellectual Property Owners Ass'n).

⁵⁴ AIPLA Amicus Brief at 4, *eBay Inc. v. MercExchange LLC*, 126 S.Ct. 1837 (2006).

Reasonable royalty calculation should be based upon a realistic valuation of the contribution to the value of the infringing product made by the invention reflected in the infringed patent. The objective is to compensate the patent owner for the relevant harm—and that harm is the unauthorized use of the invention. That valuation should focus on the invention’s particular contribution to value, not the value of the entire product manufactured by the alleged infringer.

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Sincerely,

Coalition for Patent Fairness

Business Software Alliance