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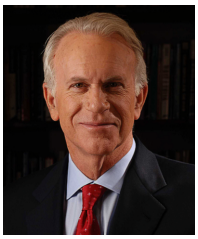
The author generally supports legislative proposals to address patent troll problems but adds that administrative enforcement of patent pools would retain their benefits and mitigate abuses.

Time to Fix the Patent System



By James K. Glassman

Republicans and Democrats don't agree on much these days, but, across party lines, there's a common and intense worry that our patent system is broken, and U.S. innovation—and thus, economic growth—are suffering.

The unanimity is astounding. Seven patent reform bills have been introduced in Congress in recent months. One pairs such unlikely co-sponsors as Reps. Blake Farenthold (R-Texas), a member of the Tea Party Caucus, and Hakeem Jeffries (D-N.Y.), who represents a majority-African-American district in Brooklyn. Another was introduced by two House members from California: Reps. Darrell Issa (R-Calif.), the pugnacious chair of the House Oversight and Government Reform Committee, and Judy Chu (D-Calif.), who has an 89 percent liberal voting record on economic matters.

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The Republican chairman of the House Judiciary Committee, Rep. Robert W. Goodlatte (R-Va.), has gotten together with the Democratic chairman of the Senate Judiciary Committee, Sen. Patrick J. Leahy (D-Vt.), to circulate a draft proposal of reform legislation that will probably be introduced after the summer recess. President Obama signed the America Invents Act in 2011, but it hasn't helped much. He has issued executive orders to fix patent problems and is urging Congress to do more.

What unites these policy makers is animosity toward an intellectual property regime that is spinning out of control. In the past, nearly all patents were owned by inventors and their companies, which used them in their own work or, in some cases, licensed them at a fee to others to use. But in recent years, investors who don't invent things themselves have been buying up patents as a business, licensing them or aggressively suing people and firms that may be infringing their IP.

Studies and Reports on Troll Business Models. The derogatory term that describes these investors, ''patent trolls,'' dates only to 2001, but the practice isn't new. It goes back more than a century and a half to Elias Howe, who assembled and licensed sewing-machine patents.

What's new is proliferation of powerful aggregators like Erich Spangenberg of Dallas, who was recently profiled in the New York Times. His firm IPNav has pulled together 10,000 patents, created a ''full service patent monetization platform,'' and sued 1,638 companies in the last five years.

The sudden explosion in expensive lawsuits that trolls have instigated mainly involves software patents, and the great fear is that these suits are putting a damper on innovation. One study found that suits by trolls, or ''patent-assertion entities'' (PAEs) increased six-fold between 2006 and 2012 and now outnumber, by 50 percent, suits filed by inventors themselves. A study by Boston University law professors Mike Meurer and

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Jim Bessen calculated that the cost to consumers of these suits created a ''patent tax'' that adds 20 percent to research and development costs. The annual price tag for the suits is $80 billion.

Those studies are cited in a thorough report on PAEs by the Manhattan Institute's Trial Lawyers Inc. project, which shows that the data on lawsuits are only part of the story. Suits are expensive for small and medium-sized businesses to fight—especially in software cases, where the discovery process is hugely complicated—so nine-tenths of cases settle. Also, says the Manhattan Institute report, ''55 percent of defendants in patent-troll lawsuits filed in 2012 have under $10 million in revenues,'' and, ''for the first time, patent trolls targeted non-tech companies more frequently than tech companies, signaling a shift toward retailers and end users of technology-related patents.''

A particularly outrageous example in the report is a company called MPHJ Technology Investments, which owns patents related to the one-button scan and send-to-e-mail function that's standard on many scanners and copiers today. MPHJ did not go after manufacturers but instead pursued ''hundreds of small and medium-size U.S. businesses that were end users of printers and scanners—seeking roughly $1,000 per worker in licensing royalties.''

Perhaps even more threatening than these private entities are ''state-sponsored'' PAEs, founded by governments. For example, the French government, along with the publicly owned Caisse des Depots, started France Brevets, a 100 million euro fund. Japan's government has launched the Innovation Network of Japan, and Korea has started Intellectual Discovery, all with the goal of collecting and monetizing patents.

France Brevets has stated that it plans to enforce its patents by giving preferential treatment to domestic companies while going on offense against alleged foreign infringers. Its first lawsuit was filed in July against an American company. These new entities—in effect, state trolls—encourage governments to abuse their regulatory power.

A Value in Theory, But Markets Aren't Working. Trolls, however, aren't all necessarily evil. They create a convenient market for buyers and sellers of intellectual property, which in the 21st century is probably more important to growth than the stuff that is bought and sold on traditional markets, from soybeans to copper to long-term Treasury bonds.

Intellectual Ventures—a PAE founded by former Microsoft executive Nathan Myhrvold, whom *The Economist* magazine says critics call ''the king of the trolls''—says on its website, ''Our goal is to grow a more efficient invention economy that will energize technological progress, potentially changing the world for the better.'' A privately owned company, Intellectual Ventures has acquired 70,000 patents since its founding in 2000.

In theory anyway, a smoothly running market for intellectual property makes life easier for innovators who want to build on existing patents. At the same time, by broadening the prospective audience for IP, it provides a greater incentive to invent in the first place.

But in practice, the markets aren't working. Barriers to innovation—in cost and complication—are rising. The reformers are proposing all sorts of solutions—for example, a ''loser pays'' rule that requires an unsuccessful plaintiff to pay legal costs, limits on discovery and on injunctions, immunity for end-users that employ off-the-shelf technology like that one-button scan function, tougher requirements for proving infringement, and reducing patent life on software from 20 years to five.

Suggestions Beyond Legislators' Broadest Bills. Gary Becker, the Nobel Prize-winning economist and expert on human capital, goes further. He advocates eliminating software patents altogether. ''Disputes over software patents are among the most common, expensive, and counterproductive,'' Becker wrote on his blog in July. ''Their exclusion from the patent system would discourage some software innovations, but the saving from litigation costs over disputed patent rights would more than compensate the economy for that cost.''

That's a bit extreme. In my view, there's no need to sacrifice innovation to reduce the costs of litigation. Still, Becker's position reflects the frustration academics and policy makers feel about the current patent system.

Even Richard Posner, a respected federal judge, has weighed in. He wrote in *The Atlantic* that ''there are serious problems with our patent system'' that ''warrant reconsideration'' by lawmakers. He did not take a position but listed such changes as forcing trolls actually to produce things and barring jury trials in patent cases.

Getting the Balance Right. Reformers have to be very careful. There are few tougher problems in public policy than constructing an IP regime that encourages and protects innovation. We have to get it right.

On the one hand, the chance to own what you produce is a spur to produce it in the first place. If I build a house, but there's no law to prevent someone from moving in without my permission, then I won't have much incentive to build another one. Patents encourage people to innovate because they get to enjoy the fruits of their innovation; they can license their patents to others and get paid (or sell the patents to a third party like a PAE, which gets paid).

On the other hand, innovation has what economists call ''positive externalities.'' My invention helps not just me but the rest of society, so smart patent policy limits ownership rights to a specific number of years. If I invent a new drug, the patent life is 20 years. After that point, generic manufacturers can use the formula, and prices fall, so more people can benefit.

The hard part for policy makers is finding the balance between encouraging innovation through ownership while, at the same time, letting as many people as possible benefit from the innovation. The worry is that voracious PAEs will stifle innovation by adding a high level of litigation taxation to technology.

America's founders understood the importance of IP and the difficulties in regulating it. Article I, Section 8, of the U.S. Constitution includes patents as the eighth of just 18 enumerated powers of Congress, along with declaring war, coining money, and regulating ''Commerce with foreign nations.''

Pay attention to the precise language. The Constitution says that Congress ''shall have the Power To . . . promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.'' A patent, then, is not just a property right. It's a tool for promoting the progress of science.

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Benefits, Dangers of a Patent Pool. One of the challenges to the progress of science today is that patent rights for the development of sophisticated new technology are decentralized—owned by many separate patent holders. ''The fragmentation of rights can increase the cost of bringing products to market due to the transaction cost of negotiating multiple licenses and greater royalty payments,'' writes David Balto, a former attorney in the Antitrust Division of the Justice Department. The answer to this fragmentation, often called a ''patent thicket,'' is to bundle all the patents in a specific technology together in a ''patent pool,'' so that an innovator can license them for a single fee.

Just such a pool ''was a responsible for the mass production of the sewing machine in the nineteenth century—a commodity that was fundamental to the success of the Industrial Revolution in America,'' wrote Adam Mossoff of George Mason University in a 2009 paper that recounts the history of the first patent pool in America, which lasted from 1856 to 1877.

While patent pools can be highly beneficial, they can also foster abuses. One notorious example involves a patent-licensing firm called MPEG LA, which in 1996 put together multiple patents from different owners, all related to the popular MPEG-2 digital television format, used in devices like mobile phones around the world. (MPEG stands for ''Moving Pictures Experts Group.'')

On its website, MPEG LA declares, ''MPEG-2 became the most successful standard in consumer electronics history and the MPEG LA Licensing Model has become the template for addressing other patent thickets. Today MPEG LA operates licensing programs consisting of more than 5000 patents.''

The danger of a pool, however, is that it can include non-essential, invalid, or expired patents, which innovators that want to get access to *essential* patents have to pay for in the overall fee. It's as if all automobile manufacturers got together and required you to buy an expensive trailer to go with the car—otherwise, no car.

To prevent this kind of abuse and to protect competition, the Justice Department has to approve individual patent pools. And so it did in 1997 in the case of MPEG-2.

Unfortunately, MPEG-2 is a classic case of what can go wrong with a patent pool. Of the original patents in the pool, half had expired by 2012. Half the remaining patents will expire by 2014 and 90 percent by 2015. Yet MPEG-2 continues to charge the same licensing fee.

Steve Forbes, CEO of *Forbes* magazine, recently wrote that ''MPEG LA's manipulative price structures are not only standing in the way of consumers being afforded access to . . . innovations, they are also driving up prices on devices that are currently available.''

DOJ and FTC Must Do Their Jobs. There is a remedy. The Justice Department and the Federal Trade Commission are mandated to oversee patent pools and mitigate abuses, but, writes Balto, ''Neither federal antitrust enforcer has challenged a patent pool in over 15 years.'' The answer is for the DOJ, especially, to do its job.

Citing the *Forbes* article, Reps. Spencer Bachus (R-Ala) and Farenthold, the chair and vice-chair of the House Judiciary Regulatory Reform, Commercial and Antitrust Subcommittee, recently wrote a pointed letter to the head of the DOJ antitrust division, asking ''what oversight, if any, does the Department of Justice provide to patent pools to ensure they are not negatively impacting businesses and consumers?''

Good question. While over-zealous regulation deters economic growth, near-absent regulation—in the case of the patent system—is harming competition and innovation.

The reason that President Obama and members of Congress on both sides of the aisle are coming together is that the government's role in protecting intellectual property is really not an ideological matter. In fact, it's not much different from protecting physical property—except that IP is more value to America's future.

This is a public policy issue that requires balance, moderation and cooperation. The current patent regime is badly broken. Now is the time to fix it.