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From Efficient Licensing To Efficient Infringement

Decisions, legislation have weakened patent rights.

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Those who have followed the U.S. patent system for an extended period are familiar with proverbs like "what goes up must come down" and "deja vu all over again," as the late great Yogi Bera once said. Indeed, U.S. patent holders have seen the strength of their patent rights fluctuate significantly over the last several decades. In 1982, the Court of Appeals for the Federal Circuit was created to harmonize patent rulings coming up from the various district courts. The Federal Circuit's early decisions reversed a period of weak patent rights, for example, by affirming preliminary injunctions against infringers, finding more patents valid and more patents infringed in close-call situations, and increasing damages awards. Patent rights remained relatively strong under the stewardship of the Federal Circuit

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until the Supreme Court began reducing the strength of rights in 2005. In a series of decisions, the court cut back on the applicability of injunctions, made it easier to find inventions obvious, and added to the types of inventions deemed ineligible for patenting, among other changes. These decisions, coupled with legislation aimed at addressing abuses attributed to non-practicing entities (NPEs), have resulted in significant weakening of patent rights over the last 10 years. In aggregate, we have experienced approximately 20 years of strengthening patent rights followed by 10 years of weakening them. In describing the evolution of U.S. patent rights, commentators often use the analogy of a pendulum by which patent rights have swung from weak to strong and back again.

This tale of two patent regimes provides a unique opportunity to examine how firms act under stronger and weaker patent rules, and to consider the economics and policy implications of both approaches. In our prior article, we examined behaviors during the period of strong patent protection in the 1990s.[1] During this period, information technology (IT) firms adopted a practice of engaging in full patent portfolio cross-licensing, using balancing payments to compensate the party with the stronger portfolio. We noted that, as a means to value each patent in each party's portfolio, such cross-licenses lacked precision—but firms valued the freedom-of-action provided by these portfolio licenses over the potential value lost by declining to examine the value of each individual patent covered by the license. We described this behavior as "Rational Ignorance" since the actors made the rational decision to remain ignorant of individual patent valuations in favor of the freedom provided by the cross-license. It is perhaps more accurate to say that during the years of strong patent rights, parties favored portfolio licensing over individual patent licensing based on a calculus that can be termed "Efficient Licensing."

Recently, various commentators have examined the licensing behaviors of IT firms under the currently prevailing regime of weakened patent rights.[2] These commentators note that in this environment of weakened patent rights, firms are making a different rational ignorance decision—namely, they are opting to ignore licensing requests from patent holders, relying on the view that most patent holders will not resort to litigation and that those claims resulting in litigation can generally be dispatched inexpensively either via AIA trials or through motion practice in district courts. Commentators label this form of rationally ignorant behavior "Efficient Infringement."

It stands to reason that, when patent rights are strong, firms will err on the side of taking a license, and when patent rights are weak they will be more likely to risk infringement. It is also unsurprising that just as some opportunists will abuse the patent system when rights are strong, others will do so when rights are weak.

Upon reflection, these behaviors are unsurprising. It stands to reason that, when patent rights are strong, firms will err on the side of taking a license, and when patent rights are weak they will be more likely to risk infringement. It is also unsurprising that just as some opportunists will abuse the patent system when rights are strong, others will do so when rights are weak. Abusive litigation arbitrage tactics practiced by some NPEs under the strong patent regime have been loudly decried, but equally egregious are the arbitrage tactics practiced by Efficient Infringers under the current weak patent regime. Given the importance of the U.S. patent system to innovation, jobs and the economy, weakening the patent system in order to trade one form of strategic behavior for another represents the assumption of tremendous risk with the potential for no net gain. Is it prudent policy to erode patent rights to the point where it is efficient to infringe? Does a patent market characterized by Efficient Infringement advance a desirable U.S. position as the locus of global innovation?

Our previous writing described the development of a robust secondary market in which patents were readily bought and sold. We explained how this secondary market made it less rational to ignore the value of individual patents in a broad cross-license since patents that added little value to such an agreement might lose sale value if included. The enhanced sales channel for patents made it less rational to remain ignorant of the value a particular patent contributes to a license. This sales channel influenced patent valuations; patent holders increasingly relied on market information in crafting their license agreements, and less on the rationally ignorant Efficient Licensing approach—this may be thought of as a "Market-based Licensing" model.

While there has long been a market for buying and selling patents, it reached significant scale in the early 2000s when speculators bought patents originally developed by Internet-based companies that had been devastated by the dot-com bubble burst. Ironically, the same speculators, later labeled NPEs, that prompted responses from the courts and Congress bringing on the Efficient Infringement regime were also the harbinger of greater market awareness regarding patent value. They drove the market toward less rational ignorance and greater rational knowledge of patent value. But the actions of the NPEs were disruptive in more than one way. While bringing about market-based valuation, their business model threatened

the status quo for powerful stakeholders, who then lobbied successfully to curtail the rights of all patent holders. This shift has in turn largely eliminated Market-based Licensing in favor of Efficient Infringement. Indeed, given the historic success of the U.S. economic system in employing market-based solutions, it is surprising, and perhaps unfortunate, that the Market-based Licensing regime was so short-lived. As a nation we have traded a Market-based Licensing system that brought with it a measure of speculation, for an Efficient Infringement regime wherein the low cost of ignoring patents covering even truly innovative technological inventions has made it attractive to break the law, rendering consensual licensing an increasingly uncommon outcome.

By all accounts, our country seems to recognize the importance to its economic success of IP creation and licensing. In 2013, the U.S. Bureau of Economic Analysis retroactively reclassified the treatment of R&D as an investment rather than an expense, immediately raising U.S. GDP by approximately 3 percent and setting the stage for future increases.[3] The U.S. historically enjoys the largest positive balance of payments for intellectual property licensing of any country, as measured by the International Monetary Fund. For example, in 2014 the United States had a net income of $88 billion based on gross receipts of $130 billion. The next highest countries, the Netherlands and Japan, had net positive balances of $10 billion and $16 billion respectively, both with gross receipts of approximately $37 billion.[4] But this leadership position was based in significant part on a U.S. patent system that provided the world's strongest rights for innovators. The policy shifts undergirding the move to an Efficient Infringement market significantly alter that calculus. Indeed, there is evidence that patent holders are seeking jurisdictions other than the United States to execute their patent licensing deals and to obtain legal redress for patent infringement.[5]

The recent degradation of the U.S. patent system will test the long history of economic prosperity associated with strengthening, rather than weakening, intellectual property rights.[6] Can we really become the first country in history to increase innovation through weaker protection for innovation, or will we simply re-learn the age-old lesson: You get what you incent? What we *can* say confidently is that the rapid erosion of patent strength places future investment in innovation at risk. It also places at risk the next generation of innovators, who are coming to market without effective patent protection for their innovations. Recent studies indicate that 30 percent of U.S. "unicorns" (start-ups with greater than $1B in valuation) have no patents and 62 percent have fewer than 10 patents.[7] Most of these firms provide software and Internet commerce products and services. They compete against entrenched incumbents with huge balance sheets and patent portfolios, many of which lobbied heavily for weakened patent rights. But why would these upstarts bother patenting their innovations in a regime of Efficient Infringement, where competitors will simply ignore their property rights? It doesn't take a crystal ball to see how this trend will play out. The threat to U.S. innovation leadership, with its attendant impact on jobs and our economy, deserves close attention to say the least. The sad history of decline of past great economies teaches us that a fall once commenced is difficult to check. "Efficient Infringement" is another way to say "it's okay to violate a constitutionally granted right." That is no less an abuse of the patent system than those practiced by NPEs. Are we satisfied with the direction in which "Efficient Infringement" points our country?

1. David Kappos, Richard Ludwin and Marc Erlich, "Your Patents: Is Ignorance Rational?" http://www.iam-media.com/Magazine/Issue/70/Columns/Your-patents-is-ignorance-rational.

2. See, e.g., Pat Choate, "Patent Theft as a Business Model," http://www.huffingtonpost.com/pat-choate/patent-theft-as-a-busines_b_508780.html; Gene Quinn, "Patent Reform Fuels Fears, Paralyzes U.S. Innovation Market," http://www.ipwatchdog.com/2015/06/15/patent-reform-fuels-fear-paralyzes-innovaiton-market/id=58743/; Joe Nocera, "The Patent Troll Smokescreen," http://www.nytimes.com/2015/10/24/opinion/the-patent-troll-smokescreen.html?_r=0).

3. See Peter Coy, "The Rise of the Intangible Economy: U.S. GDP Counts R&D, Artistic Creation," http://www.bloomberg.com/news/articles/2013-07-18/the-rise-of-the-intangible-economy-u-dot-s-dot-gdp-counts-r-and-d-artistic-creation.

4. See http://data.worldbank.org/indicator/BX.GSR.ROYL.CD/countries.

5. See, e.g., Joff Wild, "US patent leadership may be over and the IP market is changing but opportunities abound," http://www.iam-media.com/Blog/Detail.aspx?g=d2a23bb7-ed50-476c-b920-cc17481b5574; Quinn, "Patent Reform Fuels Fears," supra note 2.

6. See, e.g., B. Zorina Khan and Kenneth L. Sokoloff, "History Lessons: The Early Development of Intellectual Property Institutions in the United States," http://www.jstor.org/stable/2696565?seq=1#page_scan_tab_contents; "Patent Rights and Economic Growth: Evidence from Cross-Country Panels of Manufacturing Industries," http://www.wipo.int/edocs/mdocs/mdocs/en/wipo_ip_econ_ge_5_10/wipo_ip_econ_ge_5_10_ref_huandpng.pdf.

7. Efrat Kasznik and Lynn Dudinsky, "The Naked Truth: 30% of U.S. Unicorns have No Patents," http://www.ipwatchdog.com/2015/11/03/the-naked-truth-30-of-us-unicorns-have-no-patents/id=62842/.