RISK MITIGATION

Patents—A Growing Source of Operational Risk for Today's Boards

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John A. Amster

John A. Amster is chief executive and co-founder of RPX Corp., a leading provider of patent risk management solutions. RPX executes large-scale structured transactions on behalf of its clients, provides innovative NPE litigation insurance, and delivers in-depth market intelligence and strategic advisory services to the 120+ members of its growing client network. RPX never asserts or litigates the patents in its portfolio.

Operational risk comes in many forms, and all are of critical concern to directors. Patents are one of the least understood and fastest-growing areas of operational risk. The cost of resolving just the patent litigations brought by non-practicing entities (NPEs)—commonly known as "patent trolls"—is nearly $30 billion per year. In most NPE litigations, more than half the costs for operating companies are legal fees; in fact, the process of transferring value from patent users to patent owners often has transaction costs of 50%.

This is extraordinary inefficiency and a dangerous, growing operating risk. It should be a key concern for the C-suite and board of directors. Most companies, however, continue to treat patents and patent litigation as the province of the legal department. They are, in effect, relying on legal strategy and tactics to solve what has become a market problem. The time is ripe for boards to radically shift their thinking and insist that patents become a more integral part of their organization's strategic and risk mitigation planning.

This emerging risk is of two types: patents your company controls and those it does not. The latter category represents the most serious threat, but both require careful consideration by the board.

Risk lies in what you have …

Patents your company owns can be a valuable asset, enabling development of new products and providing legal protection for those products in the market. But outside of the pharmaceutical industry, where patents are routinely used to exclude imitators, the primary protective benefit of a large patent portfolio is its power to dissuade competitors from initiating an infringement action, for fear of countersuit. Such a threat of "mutually assured destruction" has brought equilibrium to many sectors, and thus company-versus-company lawsuits remain relatively rare (the recent Apple-Samsung litigation notwithstanding). The vast majority of patent disputes settle without ever going to trial because most companies possess defensive patents that claim technology being used by a competitor.

This may sound illogical, but it is the nature of patents today. For reasons too complex to explore here, the U.S. Patent and Trademark Office has issued a steady stream of patents over the years (2.3 million since 2000) that are often ambiguously worded with claims that overlap those of other issued patents. As a result, many patents in circulation can be plausibly seen as being infringed.

That brings us to the second, and more dangerous, source of patent risk: patents your company does not own or control.

… And what you don't

Most directors are aware of the perils of NPEs, but may not recognize just how large and expensive a risk they have become. NPEs do not make products or sell services (and therefore are immune to infringement counterclaims). Their model is to acquire patents and patent rights and assert infringement of those assets to generate settlements from the accused companies. NPEs take full advantage of the fact that so many equivocal, overlapping patents are in circulation. There are now nearly 900 active NPEs, with an estimated collective capitalization exceeding $8 billion. The impact of NPEs has grown rapidly. In 2006, there were approximately 1,000 unique defendants in NPE litigation. In 2011, that number rose to more than 3,000 separate companies, and NPE-initiated cases increased to comprise 62% of all patent litigation in U.S. district courts.

As the threat has grown in scale, the rapid and sustained rise of associated costs has made NPE litigation a priority for corporate boards. Every dollar spent on defending an NPE assertion is a dollar not spent on R&D, market development, or job creation—and this "tax on innovation" is steadily increasing. According to a comprehensive study sponsored by the Coalition for Patent Fairness, the total cost of NPE lawsuits rose from approximately $6 billion in 2005 to $29 billion in 2011 ("The Direct Costs from NPE Disputes," professors James Bessen and Michael Meurer, Boston University School of Law).

Knowledge is power, especially when tackling patent risk

Faced with this rising tide of costly NPE litigations, directors and executives need to develop strategies to assess and manage patent risk. But successful strategies are built on reliable data and, until recently, that data has been available only to NPEs. Since patent litigation is their core competence and sole activity, they have a wealth of historical information about litigation costs, settlement details, negotiating tendencies, and more. That knowledge has given NPEs a powerful advantage over operating companies.

The NPE Cost Study changed this inequitable status quo. RPX administered the interviews and managed the underlying data for the study. Many RPX clients participated and, for the first time, provided in-depth, broad-based (and anonymized) data detailing the financial and operating impact of the NPE business model.

Data alone is not a useful decision-support tool. RPX's goal is actionable intelligence, and to that end, it has built a detailed actuarial model that leverages its growing database to predict the likely frequency and cost of NPE litigation, per company. The potential outcomes reflect multiple contributors to risk, including company size, technology type, stage of corporate development, historical co-defendants and plaintiffs, willingness to settle, and many more criteria. For directors and executives grappling with a relatively new and largely misunderstood source of operating risk, this kind of intelligence is extremely valuable.

Importantly, this ability to translate litigation data into clear economic terms underscores that patent risk is at its core a market problem rather than a legal problem. Now, instead of calling outside counsel after receiving an assertion letter, management teams can make their own cost/benefit analyses, based on the quantifiable risk a particular NPE or specific patent actually represents. They can decide if it makes more economic sense to negotiate a fast and efficient business solution or to engage in a longer-term and potentially more expensive legal proceeding.

For board members, this is revolutionary and will potentially transform how companies manage patent risk. NPE litigation used to be a black box of poorly understood and extraordinarily high transaction costs. Today, it is an increasingly open book, and that is an opportunity for companies to begin rationally solving the multi-billion dollar problem of patent risk.

Next Steps: Four Questions to Ask Your Management Team

Patent risk is on the rise, but how significant a threat is it to your company? Here are four foundational questions to ask the CEO at your next board meeting:

What is our patent position vis-à-vis our competitors?

Maintaining a credible threat of "mutually assured destruction" does help ensure patent peace. The IP legal team should do an inventory of patents not only owned by your company, but also those controlled by your competitors and compare quality, applicability to current product lines, priority dates, number and breadth of claims, number of forward citations, and other factors.

Do new product offerings create exposure?

Entering new markets with new competitors can shift the equilibrium of defensive patent portfolios. It is important to ensure that your patent estate provides a credible threat of countersuit against all possible company plaintiffs.

Are any of our competitors/peers feeling pressure to monetize their patents?

Companies that are underperforming financially may choose to boost revenue growth by asserting their patent portfolios (or selling them to an NPE). Recognizing this risk early enough may allow your company to preemptively acquire or license these dangerous assets before they become a costly legal problem.

What is our plan to limit damage from NPE assertions?

Again, knowledge is power. Tracking the market for patents to know which patents have been sold (and to which NPEs) can provide advance warning of an assertion campaign. Monitoring and characterizing active NPEs can help anticipate the likelihood of your company being targeted. Analyzing past acquisitions and settlements can help guide strategies for how to prevent or limit damage from a particular patent or NPE.