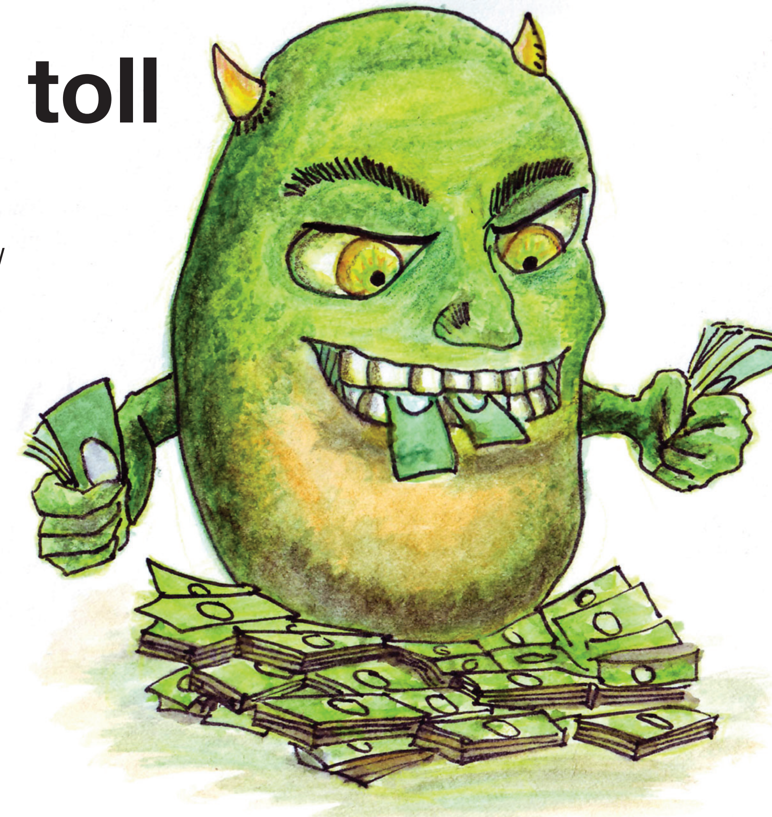
The patent troll toll



RPX Corporation's **John A Amster** explains why trolls are a large and growing tax on innovation

At a Congressional hearing in March before the US House Committee on the Judiciary, the general counsel of Cisco Systems testified that the networking industry leader is spending "more than $50m per year" fighting patent infringement litigations brought by non-practising entities (NPEs). Cisco had to defend itself against nearly 50 such lawsuits in 2012. That is just one year and just one company, and Cisco is not alone. More than 2,400 technology-focused companies were sued last year by NPEs.

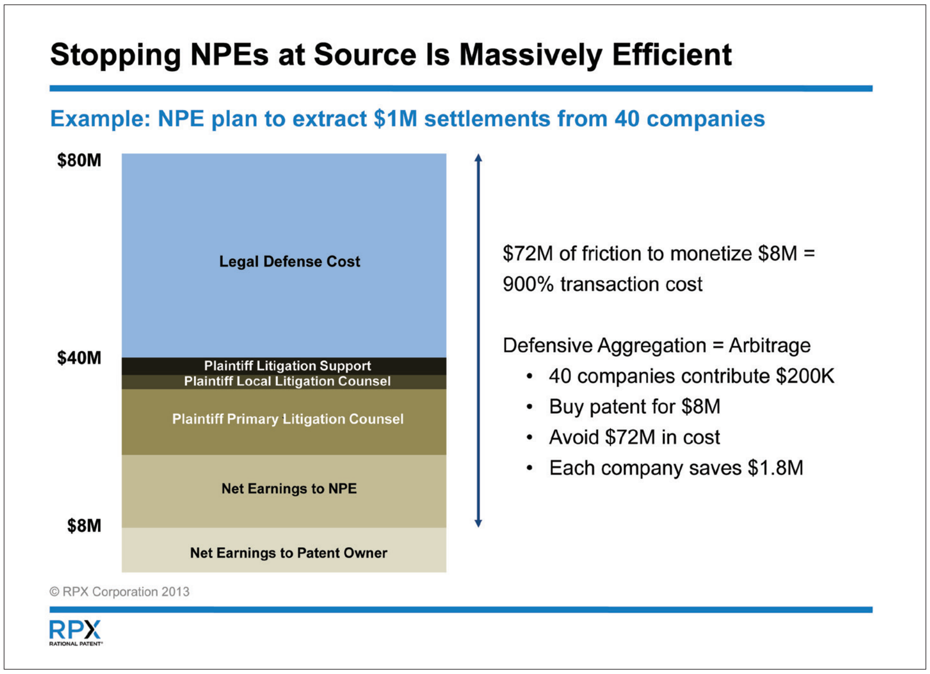
RPX is constantly studying NPE activity, trends, dynamics, and the costs involved with NPE litigation, and we have observed that the total cost these companies incurred to fight and settle those litigations was nearly $11bn. This is a huge and growing "tax on innovation" that steadily reduces a company's profits, working capital, and the ability to fund research and development.

NPEs – we at RPX prefer this to the more pejorative "patent troll" – have clearly mastered their maddeningly simple and effective business model: acquire patents, identify operating companies that may be infringing those patents, and bring legal action to generate a payment. As long as the US Patent and Trademark Office (USPTO) continues to approve patents with claims that overlap previously issued patents, there will be a lot of intellectual property in circulation that can plausibly be seen as infringed. This is a burden for operating companies that will not be going away any time soon.

The success and growth of the NPE model is reflected in the numbers. As recently as 2006, there were approximately 1,000 unique defendants in NPE litigations. In 2012, that had grown to more than 2,400 separate operating companies, and NPE-initiated cases comprised fully of 65% of all patent litigation in US district courts. Today, there are more than 800 active NPEs with a collective capitalisation of more than $8bn in patent-buying power.

NPEs are becoming more and more costly for operating companies. Despite the signing of the America Invents Act, the problem continues to grow, and the federal government continues to search for answers. The Federal Trade Commission and US Department of Justice co-sponsored a workshop last year designed to investigate the economic impact of the NPE business model. RPX submitted testimony at the workshop, providing our data and analysis, noting the following several key trends that indicate the NPE tax on innovation is here to stay and likely to keep growing:

- The market for patents is thriving. RPX is one of the most active participants in the patent market. We see nearly every brokered patent transaction, and on average, review more than 70 portfolios every month. Each portfolio can comprise dozens or even hundreds of individual patents and we believe more than half of those that transact are bought by NPEs. In 2012 alone, we estimate that NPEs acquired more than 170 portfolios, significantly expanding their ability to bring infringement assertions.
- The costs of resolving NPE litigation are significant. Over the past year, RPX has been administering a large-scale 'NPE Cost Study' – the first comprehensive review of costs of NPE litigation for operating companies. The study was undertaken at the behest of the US General Accounting Office to provide Congress with quantifiable information about the impact of NPEs on American business. Our data from the study showed that the median cost to resolve an NPE case in 2012 was approximately $550K in combined legal expense and settlements. This somewhat masks the significant impact a NPE litigation often has, however. A quarter of NPE cases cost the defendant nearly $2m each. The top five percent of cases cost more than $19m a piece. NPE litigation is a huge tax on innovation and the tax is made more threatening for operating companies by the uncertainty of its scale.
- Legal expense is a significant portion of the total cost to resolve an NPE case. In all but the most expensive litigations we analysed for the NPE Cost Study, legal expense represented at least 50% of the total costs to resolve the case. Even in cases where an allegedly infringing company chooses to pay the patent owner for a technology licence, this is an extraordinarily wasteful way to compel payment. In essence, it is a transfer of value with 50% transaction costs. Again, a huge and inefficient tax that drains resources that would otherwise be funding innovation and other value-creating activity.
- Defendants in NPE cases almost always settle. Fewer than 5% of NPE litigations continue to a verdict or ruling. On average, defendants stay in the case for less than 12 months before settling. This only reinforces the notion that, for all intents and purposes, these cases are transfers of value between patent users and patent owners. Using the legal system to make that transfer – and incur 50% transaction costs – makes the tax on innovation far more burdensome than it needs to be.



Let us consider the economics of a typical NPE patent monetisation campaign (this example is representative; the number of defendants and dollar amounts can vary, but the general scale of the financial impact is fairly consistent from campaign to campaign).

A prominent NPE was recently raising investment capital to assert several patent portfolios. Typical of the NPE business model, the patents were not owned by the NPE but were being asserted on a contingency basis. The inventor of the patents retained ownership and would receive a share of any licence or settlement revenue generated by the campaign.

The NPE estimated that it could sue 40 operating companies that appeared to be using the patented technology, and it expected to extract an average settlement of $1m from each, for total revenue of $40m. Of this $40m in settlements, the NPE expected to pay plaintiff's counsel $5m and keep $27m for itself and its investors. The inventor/owner would receive $8m or 20% of the total settlement value.

Remember, too, that the campaign would also cause $40m in expense incurred by the defendants to fight the court case. Again, legal expense is typically half the total cost; $1m in settlement generally requires a $1m investment in defence counsel and other court costs. So, the total cost of the campaign would be $80m to produce a payment to the owner of the assets of $8m. This implies that the transaction cost to transfer value from the users of the patents to the owner is $72m.

It is an astonishing realisation. And it actually understates the impact of NPE litigation because it does not take into account all the indirect costs associated with a patent infringement case. Senior management are distracted by preparing for the case. Engineering staff must spend time – often far from corporate headquarters – providing depositions and participating in the discovery process. New product development can be delayed or shelved.

The goal for operating companies, of course, is to reduce this drain on resources that would otherwise be spurring innovation and driving growth. There have been numerous efforts to address the problem legislatively and through regulatory changes, but ultimately, the NPE problem is less a legal problem than a market problem. The patents at the heart of the NPE business model are assets. They have value. And that value will be transferred between users and owners. The key to reducing the tax on innovation is establishing more objective market mechanisms to make the exchange of patent value more efficient.

To make this happen, we need to make the patent market more transparent. Specific tactics include establishing objective criteria for patent validity, clearer determination of infringement, and earlier valuation of real damages. RPX has also been compiling a large database of patent transaction and litigation cost information. This data is truly unique and has never been available in the patent space – and this lack of visibility has only exacerbated the NPE problem. Our belief is that if all market participants have trustworthy information about the patents they own and the costs of monetising them, there would be a steady movement away from relying on litigation to exchange patent value. A more open market is a more efficient market, and that would be good for patent owners and certainly for operating companies.

RPX and others have been working to make the patent market less opaque and less reliant on litigation as the favoured means of conducting transactions. RPX has built a network of more than 145 companies committed to this approach. Each of our members pay an annual subscription and we deploy this growing pool of capital to acquire patents on behalf of the entire membership (each member receives a licence to every patent we acquire).

To date, we have invested more than $600m in patent acquisitions, and we conservatively estimate that the network's ability to clear high-risk patents has reduced our clients' collective NPE risk by approximately 40%. As we continue to scale up the network and expand our acquisition activity, we believe we can further reduce the cost of NPE litigation for members of the RPX network.

Clearly, this more collaborative, market-based approach is making progress and more patents are being transacted without litigation, but there is still too much waste in the system. Nonetheless, we remain optimistic at RPX. The patent market is growing increasingly rational. As operating companies increase their support for a market-based approach to patent monetisation, they will steadily reduce the enormous transaction costs they are now paying, and those avoided "tax" dollars can once again be spent on innovation.

Author

John A Amster is the CEO and co-founder of RPX Corporation. Prior to co-founding RPX, he was the general manager of strategic acquisitions and vice president of licensing at Intellectual Ventures, responsible for strategic acquisitions of patent portfolios as well as developing the software and e-commerce licensing programmes. John started his career as an associate at Weil Gotshal & Manges, where his practice included mergers and acquisitions, equity investments, venture capital financings, intellectual property licensing, and patent litigation. He received his JD from Benjamin N Cardozo School of Law and his BA from Middlebury College.