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COMMENTARY

Federal Trade Commission Releases Long-Awaited Report on Patent Assertion Entities

Three years after initiating an extensive sector study under section 6(b) of the FTC Act, the Federal Trade Commission has issued its report on the activities of patent assertion entities ("PAEs"). The report, titled *Patent Assertion Entity Activity: An FTC Study* ("PAE Report"), sets forth the FTC's analysis of PAEs' patent acquisition, patent assertion, and licensing activities. Recognizing that PAEs "reflect[] the legal environment created by the U.S. patent system," the PAE Report identifies four specific recommendations for legislative and judicial reform intended to reduce the burden of nuisance litigation. Several of the FTC's recommendations have already been implemented, at least in part, through recent U.S. Supreme Court decisions, amendments to the Federal Rules of Civil Procedure, and judicially created doctrines. Notably, the PAE Report does not contain any discussion of an impact on competition, thereby implying that the patent laws, rather than the antitrust laws, generally are best suited to address issues involving PAEs.

Background

The FTC's PAE Report follows a number of previous policy statements involving intellectual property. Together with the Antitrust Division of the Department of Justice, the FTC has issued statements regarding the application of antitrust law to aspects of intellectual property. These include the 1995 *Antitrust Guidelines for the Licensing of Intellectual Property* and the proposed revision to those Guidelines published last month, and the 2007 report *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition*. Acting alone, the FTC has published reports commenting on aspects of IP law that it believes affect competition, including the 2003 report *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy* and the 2011 report *The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition*. The PAE Report continues the latter set of reports. As such, it focuses solely on aspects of patent law and does not discuss the enforcement of antitrust law.

The FTC's Methodology and Key Findings

The PAE Report defines a "PAE" as a business that acquires patents from third parties and seeks to generate revenue by licensing those patents to or asserting them against alleged infringers. This definition excludes most individual inventors, research labs, universities, and companies that develop their own patent

portfolios. The PAE Report distinguishes PAEs from non-practicing entities ("NPEs"), which it defines as "patent owners that primarily seek to develop and transfer technology."

In contrast to most studies of PAEs, which rely on publicly available information, the FTC based the PAE Report on non-public information collected from leading industry participants, including extensive information from 22 PAEs and more than 2,500 of their affiliates and related entities. The responses permitted the FTC to analyze information regarding confidential aspects of the PAEs' activities, including the terms on which they acquire patents, their use of demand letters, the specific terms of their patent licenses, and royalties and other revenues they collect.

Continuing a theme developed in its 2011 report, the FTC considers PAEs to engage in *ex post* activity (assertion of patents after companies have already developed and marketed products) as opposed to *ex ante* activity (licensing of patents before products are developed and marketed). The FTC distinguished between two types of PAEs—"Portfolio PAEs" and "Litigation PAEs." The FTC concluded that Portfolio PAEs typically hold broad portfolios and negotiate licenses to a substantial part or all of the portfolio. Litigation PAEs, by contrast, typically file infringement lawsuits against multiple manufacturers or end-users based on a small number of patents.

The FTC determined that, while Portfolio PAEs account for only 9 percent of the reported licenses, they generated 80 percent of the reported revenue. The FTC concluded that the Portfolio PAEs subject to the study "typically funded their initial patent acquisitions through capital raised from investors, including institutional investors or manufacturing firms." On the other hand, the subject Litigation PAEs "operated with little or no working capital and relied on agreements to share future revenue with patent sellers to fund their businesses."

The PAE Report notes that the "FTC did not observe Study PAEs successfully generating low-revenue licenses by sending demands, but not suing targets." As a result, the FTC determined that "demand-letter reform, on its own, would not fully address the potential negative repercussions of PAE activity." Critically, the FTC found that the Litigation PAEs typically settled lawsuits by entering into licenses yielding total royalties of less than $300,000. Accepting an estimate of $300,000 as the lower bound of the typical discovery costs in a patent suit, the FTC concluded that the activities of Litigation PAEs are "consistent with nuisance litigation." This finding echoes the Supreme Court's recent recognition that 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. Some companies may use patents as a sword to go after defendants for money" in order to "obtain payments that are based more on the costs of defending litigation than on the merit of the patent claims." *Commil USA, LLC v. Cisco Sys., Inc.*, 135 S. Ct. 1920, 1930 (2015).

The FTC also determined that the information and communications technology sector is most affected by Litigation PAEs' conduct, noting that "of all the patents held by PAEs in the FTC's study, 88% fell under the Computers & Communications or Other Electrical & Electronic technology categories, and more than 75% of the Study PAEs' overall holdings were software-related patents." The Supreme Court's recent decision in *Alice Corporation. v. CLS Bank International*, 134 S. Ct. 2347 (2014), and its progeny have substantially blunted the impact of patent-infringement assertions based on software claims.

The PAE Report's Recommendations

While recognizing that infringement litigation is an important aspect of protecting patent rights, the FTC concluded that nuisance infringement litigation can "tax judicial resources and divert attention away from productive business behavior." In keeping with its conclusion that PAEs are a consequence of U.S. patent law, the FTC proposed recommendations for legislative and judicial changes regarding patent litigation:

- Congress, the Judicial Conference, and individual courts should promote court management practices that take account of the asymmetry in the discovery burden between Litigation PAEs and alleged infringers. One possible step identified by the FTC would be to limit discovery before preliminary motions are decided. This recommendation is arguably implemented, at least in part, by recent amendments to Federal Rule of Civil Procedure 26(b), which provides that discovery should be calibrated "proportional to the needs of the case."

- Congress and the Judicial Conference should amend Federal Rule of Civil Procedure 7.1 to expand the financial and other related relationships that must be reported, which would allow "a better understanding of financial relationships relating to firms that may appear in the courtroom."

- Because a manufacturer typically has a better understanding than end-users of a disputed technology and its alleged use in an accused product, Congress and the Judicial Conference should enact provisions to encourage district courts to stay infringement actions against end-users pending resolution of an action against the manufacturer. This proposed recommendation endorses the judicially crafted, but infrequently invoked, customer-suit exception: "When a patent owner files an infringement suit against a manufacturer's customer and the manufacturer then files an action of noninfringement or patent invalidity, the suit by the manufacturer generally takes precedence. This 'customer-suit' exception to the 'first-to-file' rule exists to avoid, if possible, imposing the burdens of trial on the customer, for it is the manufacturer who is generally the 'true defendant' in the dispute." *In re Nintendo of America, Inc.*, 756 F.3d 1363, 1365 (Fed. Cir. 2014).

- As courts apply the plausibility standard of pleading in patent infringement cases, they should ensure that complaints provide sufficient notice to accused infringers. The FTC's proposed recommendation aligns with the Supreme Court's guidance that tightening pleading requirements "serves the practical purpose of preventing a plaintiff with a largely groundless claim from tak[ing] up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 546 (2007).

In comparison with the 2003 and 2011 reports, one thing is conspicuously absent from the PAE Report: any discussion of competition. In its earlier reports, the FTC had described the potential impact on competition of perceived shortcomings of patent law and the patent system. The FTC relied on this potential impact to justify its recommendations. In the PAE Report, however, the FTC barely mentions competition. This may be due to the FTC's finding that nuisance suits, despite their inefficiency and the inconvenience they cause, often settle for less than $300,000 and appear unlikely to have a significant competitive effect. The PAE Report appears to confirm that, following an extensive review of non-public information, the FTC continues to believe that in most cases, PAEs are beyond the scope of concern of the antitrust laws, and instead are best left to be dealt with as a matter of patent law.

Click here to read the FTC's PAE Report.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Geoffrey D. Oliver
Washington
+1.202.879.5447
gdoliver@jonesday.com

Sasha Mayergoyz
Chicago
+1.312.269.1572
smayergoyz@jonesday.com

David M. Maiorana
Cleveland
+1.216.586.7499
dmaiorana@jonesday.com

Joseph M. Beauchamp
Houston
+1.832.239.3835
jbeauchamp@jonesday.com

Greg Lanier
Silicon Valley
+1.650.739.3941
tglanier@jonesday.com