

In the world's history, certain inventions and discoveries occurred, of peculiar value, on account of their great efficiency in facilitating all other inventions and discoveries. Of these were the arts of writing and of printing, the discovery of America, and the introduction of Patent-laws.

—Abraham Lincoln, 1859





Roadblocks or Building Blocks?

BY BRUCE BERMAN

Most companies are reluctant to get the best return on their most valuable assets. Shareholder value be damned. Fear of provoking costly lawsuits plays a part. So does confusion about what intellectual property is and how best to deploy it. Being publicly branded a patent “troll” adds to the turmoil.

Patent trolls are controversial not because of the destruction attributed to them, but because they strike at the heart of the complex relationship between innovation and commerce. The term has become synonymous with the unfair assertion of IP rights and extortion of damage payments. An Intel Corp. lawyer came up with the name in 2001 in response to a rash of attacks on the company’s inventions, apparently from financial speculators who acquired random patents from failed companies and independent inventors that related to Intel products.

The author wishes to thank *IAM* magazine for allowing him to use its pages to develop these and other ideas, which are not necessarily the opinion of Brody Berman Associates.

FIGURE 1.1



Source: Kim Hart/Roger Harding Picture Library

Trolling for Dollars. “It’s going to cost you to invalidate my patent,” nuisance asserters say. “Pay a law firm to defend your company and waste time and money, or pay me less to go away.”

These asserters were not in the business of manufacturing micro-processors or semi-conductors, but in recovering damages and collecting royalties on the unauthorized use of their rights—kind of a “gotcha” business. But despite Intel’s legitimate pain, there is a distinct difference between those gaming the system in search of a quick buck and those legitimate purveyors of patent value who are able to acquire cheaply or otherwise gain control of important patents that read on others’ products intending to make a profit. To the defendant they may look the same. A true troll might ask hundreds of large companies for \$50 million or more but accept a quick settlement for a few hundred thousand dollars, less than the cost of preliminary litigation, to disappear (Figure 1.1).

A patent is a negative right. It does not allow the owner to practice an invention but confers the privilege to defend it. Unfortunately, patentees cannot dial 911 for the local police and say “Arrest that man. He’s stealing my invention.” They need to bring an expensive, time-consuming suit, something small companies and independent inventors can seldom afford. The average patent suit costs \$3.5 million, and many significant ones are \$10 to \$15 million. Some exceed \$60 million. Litigation of this type has been called “the Sport of Kings.” Today, it can cost a defendant \$1 million to neutralize a single, glaringly weak patent, something even large companies find daunting.

WORTHY OPPONENTS

Those with bulging patent portfolios in the past relied on smaller companies and independent inventors to lack the resources or hubris to do battle. Today, they are finding them worthy opponents. In fact, an independent inventor’s very lack of portfolio patents for a defendant to counterattack has become a new source of leverage. High costs, the increased uncertainty of issued patents, better competitive analysis, and broader interest by private investors in strategic rights have caused the tables to turn.

Astute investors have discovered how weaknesses inherent in the patent system regarding *pendency* (the time it takes a patent to issue) and *validity* (whether it should have been issued in the first place), coupled with inadequate intellectual property defenses, can be exploited for financial gain. They are aware of how vulnerable many large, risk-adverse companies are, and how, in most cases, it makes business sense for them to settle rather than take their chances before judges or juries. In the past, finding expert IP counsel to take a patent assertion was close to impossible. Law firms did not wish to support smaller entities against what could be current or future clients. Although it is still difficult to

get a major IP law firm or practice to take on some patent assertion cases, well-funded independents today are finding it easier to get quality representation, especially if they pay their lawyers a percentage of what they recover. Indeed, the high cost and protracted length of patent disputes, coupled with the uncertainty of patents being issued today and the tendency of courts to uphold them, have set the stage for a patent crisis of global proportions. (Thirteen of the top 20 recipients of U.S. patents in 2004 were foreign-based companies.) The crisis affects everything from the high cost of research and development to the pace and quality of innovation, as well as shareholder value.

Eighty percent of the market value of S&P 500 companies is attributed to intangible assets, much of it patents and trademarks. With patent rights less certain and more frequently put to the test, even companies with well-built portfolios are vulnerable. But doing business in a market-based system means that all asset holders have equal right to maximum value, even if some have acquired a strategic advantage. Many companies are discovering that filing for and receiving a lot of patents is a less effective deterrent than it once was. The National Academy of Sciences is calling for more funding for the U.S. Patent and Trademark Office (USPTO), where 3,000 examiners handle some 350,000 applications annually, often with far too little time and experience to identify the all-relevant prior “art” to determine if an invention is truly original.

Anti-troll advocates say that examinations often result in many patents being granted that should not see the light of day. Studies show that half of all issued U.S. patents should not have been approved and that the USPTO green-lights more than 95% of all original patent applications. Patent examinations must improve. However, it is naïve to think that this change alone will solve all of the ills of an eternally overburdened, yet essentially reliable, patent system. Patent holders, regardless of size, financial commitment, or commercialization strategy,

have the right to prevent unauthorized use of their inventions. Unfortunately, regarding patents as financial assets is a more difficult concept for some than others.

DISTINGUISHING PATENT TROLLS FROM INDEPENDENT ASSERTERS

Independent asserters is a more accurate term than trolls for those who choose to defend invention rights against infringers by entering into a licensing agreement or, if necessary, filing a lawsuit. This is more than semantics. Thoughtful IP owners are advised to refrain from applying labels that could be used to denigrate their own best practices. There is no prohibition against acquiring, owning, or enforcing patent rights without practicing them, or in deploying intangible assets wisely. It is no crime for patentees to expose weaknesses and ask for reasonable royalties, if they can prove their rights are being infringed. The paradigm shift reflected in how IP rights are identified and deployed may be frustrating for some, but it is surely here to stay. Profiting from innovation and providing value to shareholders may require that portfolio owners think more like their attackers. Innovative IP management strategies help make innovation pay.

Some companies may be taking a page from the independents' handbook. *Newsweek* and other sources report that Sony, Intel, Nokia, and Microsoft, among others, have invested anywhere from \$350 to \$600 million in a patent acquisition fund. Google and eBay also are part of the group. What the fund plans to do with these patents is unclear, but a significant investment return is expected. Other companies with large IP portfolios are even segregating their assets by placing them into a special-purpose entity (SPE) remote from easy counterassertion.

Innovation is the developed world's greatest asset. Although companies need more reliable, better-researched, and timelier patents, they

also need more efficient mechanisms for resolving disputes. Perhaps the greatest threat to return on innovation (I call it, ROIP) is the one-two punch of uncertainty and cost. Defendants have a good point. It should not require a million dollars nor take two or more years to prove that a dubious patent is invalid. Patent disputes are inevitable. How they get resolved is not.

Many of the large patentees that protest loudest ultimately rely on USPTO inefficiencies to build, defend, and profit from their inventions. It would be terrific if the USPTO (and the European Patent Office and Japan Patent Office) harmonized to issue more reliable patents that could not be so readily, and expensively, invalidated. (The rate is about one in three.) But because of high costs and difficulty retaining experienced examiners (who often go to work for law firms), that change is not likely to occur any time soon. Traditional patent litigation may not be the solution, but neither are unrealistic expectations about improving examination standards or paying lip service to patent quality.

Companies started the IP wars in the 1980s with significant resources—large patent portfolios and huge litigation war chests and the patience to dig in for the long haul. At that time, few inventors and businesses had sufficient means to defend themselves. There was little for most active filers to fear. Today, well-informed and well-funded patent owners, and even law firms, are prepared to challenge complex invention rights. The takeaway: large patent portfolios do not necessarily consist of relevant or reliable patents, and, as a result, some companies are vulnerable.

Like nuclear powers, patentees with significant portfolios are armed to defend themselves primarily against their world-class peers. Mutually assured destruction is reason enough not to deploy all of the weapons in their arsenals. Many disputes are settled with gentlemanly cross-licenses. However, in a guerrilla war—the kind independent owners are likely to wage—Goliaths are often more vulnerable than Davids.

Companies do themselves a disservice by whining about the unfairness of the patent system, which they may have helped perpetuate. Until now, many have talked about the need for patent quality but have done little, or, at least, not enough, to facilitate it. It is time for truly innovative companies to step up. Stronger, better-researched patents, smarter enforcement strategies, and more prudent approaches to licensing and dispute resolution and IP asset monetization should be the rule, not the exception. Most patentees agree that granting exclusive rights on truly new inventions and features, and establishing their value as intangible assets, has a generally positive long-term effect on innovation and shareholder value. Companies' reluctance to manage their IP proactively, for fear that doing so might be seen as unethical or peripheral to their core business, need to be introduced to the 21st century. They also need to be less arrogant about the ubiquity of their portfolios, despite their bulk or cost. The fact is, some companies' patents are more questionable and short lived than they are willing to admit. Smart investors are in a better position than ever to prove it.

HIGH-STAKES POKER

Determining where patent extortion ends and responsible IP management begins is a question that should keep management up at night, but it's probably not even on their radar screen. Few CEOs are asking questions like, "How do we know we are getting a proper return on our IP?" or "Have we reserved sufficiently for possible infringement assertions in our industry, legitimate or otherwise?" Corporate officers and directors have a legal and moral obligation to manage all company assets for maximum shareholder value. This means acting strategically to exact maximum return on intangibles like innovation and patent rights. How many are at least considering deploying patent rights for ROI and not for market share? Not too many. *IP Frontline* estimates

that at IP-rich Cisco in 2004, for example, the CFO was spending approximately 90% of his time on just 25% of the company's market value. I would wager that most CFOs spend little of their precious time managing their company's most important assets. This is in part because tangibles like real estate and inventory are much easier to deal with under GAAP than intangibles like IP rights which, for accounting purposes, still are swept into "goodwill." The somewhat puritanical notion that there are more acceptable and unacceptable ways of making innovation pay speaks more to a lack of understanding of IP market dynamics than to higher ethics. In the early 1990s, Texas Instruments busted open this myth with a series of aggressive and lucrative patent assertions.

More dangerous than trolls is the notion that it is wrong to use IP such as patents and know-how (trade secrets) and knowledge of the patent system for financial gain. Companies employ tax strategies to the benefit of shareholders, so why not patent strategies? It's difficult to condone the deployment of patents that should never have been issued in the first place or are taking too long to issue. However, they exist in every patentee's portfolio, and various levels of dispute resolution (costly as they may be) exist to sort things out. It is not a crime to buy low and sell higher.

Patent enforcement is a high-stakes poker game. Sometimes it costs money to call a bluff; generally, the better bank-rolled survive, but not always. The inequities of the patent office are applied fairly democratically. Patent reform is not an easy fix. Vested interests divide even companies within the same industry, let alone independent inventors and R&D behemoths. Large portfolio owners use the system against competitors small and large, and so, too, do independent patent owners, who don't practice them, use the system against defendants. No matter how they are acquired, enforced, or otherwise monetized, the same rights exist for all patent owners, regardless of their business strategy

or capital investment. Some patentees, however, are better prepared to profit from companies' weaknesses than others. Similar to First Amendment and free-trade rights, it is potentially dangerous to apply patent protections selectively because defendants appear to have more at stake. Assuring primary and secondary IP owners their due, while painful for some, typically leads to higher asset values for all.

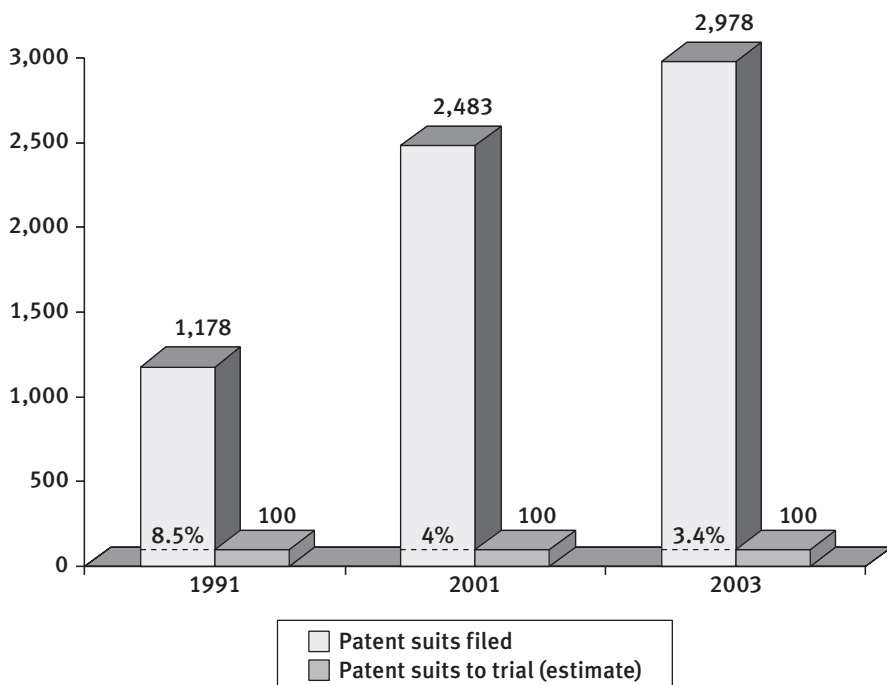
Some independent owners purchase rights from down-on-their-luck inventors who cannot afford to enforce their rights; others share with inventors in the potential recoveries. Most are willing to put their money where their accusations are. This newfound perseverance scares the heck out of companies that are not used to having their freedom to operate challenged by a relative small fry.

The upswing in patent suits (152% over a recent 12-year period) and reluctance to go to trial (Figure 1.2) because of cost and uncertainty illustrates that, despite the R&D dollars and legal investment that underlie many IP portfolios, they afford less protection than they appear to provide. Companies' desire to minimize risk has grown. Demonizing all patent asserters adds to the confusion. It makes it more difficult for CEOs, board members, and others to distinguish between shakedown artists out for a quick buck from those that can inflict lasting damage. The business media, which is ill-informed, fans the flames of these misunderstandings. Consider the following example.

A DOUBLE STANDARD FOR IP ASSETS

Donald Trump is planning his next Manhattan skyscraper. He has acquired a suitable site on First Avenue, near the United Nations. A small parking lot, 20 feet wide, blocks access to part of the proposed building's lobby. The newly signed lease on the lot does not expire until 2011. If Trump wishes to build his luxury tower soon, he will have to purchase the land and acquire the lease at a hefty premium to the market.

FIGURE 1.2 MORE IP DISPUTES, FEWER TRIALS



Source: © Brody Berman Associates, Inc.

Patent suits are up 152% over a 12 year period between 1991 and 2003. Over the same period, the number of costly trials is virtually flat at about 100. As a percentage of suits filed, patent trials are actually going down. The risk of having to pay damages, general uncertainty about the outcome of disputes, and legal fees have been blamed for the settlement trend.

In this example, the astute parking lot owner is likely to be viewed as a smart businessman, a capitalist, who through vision, luck, or both has beaten The Donald at his own game. This person is not preventing progress; he is merely making it a little more expensive for Trump, and possibly his tenants, who are prospective luxury condominium owners. Such is the cost of doing business in New York City. However, if an individual or company controlled a strategic intangible asset, such

as a patent, that blocked an optical switching system from being sold or the introduction of a generic drug, the cry would likely be “unfair competition.”

Patent exploiters who do not manufacture or practice what they invent tend to be seen as those who impede progress. They are painted as extortionists, or worse. Real estate speculators, however, no matter how ruthless or profitable, are seen as merely shrewd investors. A double standard exists when it comes to generating a return on intellectual assets, especially patent rights. Large portfolio holders must be careful what they wish for. Discouraging the market from determining value can be costly over the long haul. IP stakeholders take note.

Part of the problem is that IP assets are not easily defined. A combination of innovation, market demand, and legal rights, patents are highly complex, and their role in most products is not readily apparent. Rights violations are difficult to identify, expensive to document, and arduous to litigate. Although valuable patents are deserving of the recognition, when it comes to enforcing them, they are rarely afforded the same level of respect as worthwhile hard assets, such as real estate or natural resources. Compounding the problem is the proliferation of and access to digital content, such as music, movies, and books. Most law-abiding citizens believe that because good copies of digital content are easily made, they are there for the taking. If a teenager leaves a Virgin Megastore with the latest 50 Cent CD in his pocket and no sales receipt, he is shoplifting. If he downloads the same content from the Internet or a friend's CD and burns onto his PC or uploads into his iPod, he is exercising his rights under freedom of expression. Right.

It's amazing how many intelligent investors (Ben Graham, forgive me) and sophisticated, well-meaning executives still have difficulty taking intangibles seriously. To be fair, valuing IP is not an easy task. Even describing it can be a challenge. Unlike the equity, bond, or real estate markets, most patents are illiquid, and transactions are seldom

transparent. A common vocabulary for describing IP assets, strongly suggested by the U.S. Securities and Exchange Commission (SEC) and the Licensing Executives Society, has yet to be adopted. New Financial Accounting Standards Board (FASB) accounting regulation established in 2001 require intangible assets included in an acquisition, such as IP, to be valued and written down within one year if they fail to meet certain impairment tests. No longer can companies dump intangibles into goodwill or allow them to languish for 20 years or more as part of an expensing schedule. This is a good start, but no cigar.

The term of limited exclusivity (that ends 20 years from filing in the United States) conferred on patents by the various governments in return for disclosing the details of an invention is designed to foster innovation, not impede it. In general, the U.S. patent system has done an exceedingly good job at achieving this goal. Disputes are the inevitable by-product of more rights and greater complexity, especially in a knowledge-centric economy that places a high premium on valuable ideas. An orderly, less contentious market for exchanging IP rights not only facilitates demand, but it encourages more accurate pricing and fuels investment in innovation. Unfortunately, it is easier discussed than established.

TOLLS, TROLLS, AND U-TURNS

Few patents, no more than 3% to 5% by most accounts, have significant value. Even worse, not many people are clear about what gives the valuable ones their importance. Speculating on IP rights is not very different from investing in real property. The difference is that a ready market for commercial or residential properties helps establish price stability and generate demand. Most people get it when it comes to bricks and mortar, but few do when it comes to prime IP assets. Taking a financial position in an intangible asset, whether the owner plans

to commercialize or otherwise exploit it, should not be viewed as an unnatural act.

Several years ago an inventor decided to license key telecom patents he once had owned and practiced. His tiny company has generated more than \$1 billion, almost all of it profit, through 2005 because he has enforced patents he owns that others require to do business. But a toll road is not necessarily a “troll” road (It certainly is not a one-way street.). Although the toll road presented by royalty payments may have cost some companies and consumers in the short run, it also increased the value of new technologies and products, and created a stronger market for related patents. In all likelihood, it increased shareholder value for licensees by hundreds of millions of dollars.

Savvy IP entrepreneurs are no more responsible for impeding progress than were speculators who purchased land in Kansas in the 1860s in anticipation of the transcontinental railroad. Nobody likes to pay a toll if they don’t have to, but riding on a smoother, straighter highway can save considerable time and money. For an innovation-based company, it can make a world of competitive difference. A traveler can try to find his or her own route, but it is often not worth it. The Kansas speculators were neither settlers nor railway owners, but businessmen who sought to buy land cheaply and then either lease it or resell it at a higher rate. At first, the railroad companies were indignant about having to pay a toll to complete their route. In the end, cooler heads prevailed, and the roadblocks became building blocks for wealth on the new frontier.

