



# INTELLECTUAL PROPERTY COMMITTEE

## Public Domain

The Newsletter of the Antitrust Section's Intellectual Property Committee



### Special Edition – Commentary on the FTC's Recently Released Study on Patent Assertion Entities (PAEs)

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# The FTC PAE Study: A Cautionary Tale About Making Unsupported Policy Recommendations

By Joshua D. Wright and Douglas H. Ginsburg<sup>1</sup>

In October 2016, the Federal Trade Commission (FTC) released its long-awaited case study examining the business practices of 22 Patent Assertion Entities (PAEs).<sup>2</sup> We support the FTC's use of its unique 6(b) authority to conduct important research that will contribute to policy debates within the scope of its dual missions of competition and consumer protection. The PAE Study is no exception. We will share some of our methodological disappointments with the PAE Study, but it is important to note that it does make some valuable contributions to our understanding of PAEs.

One important contribution of the PAE Study is that it clarifies that the FTC does not view PAEs as presenting an antitrust problem requiring an antitrust remedy, but rather as a litigation problem arising out of issues with patent quality. While this is consistent with our view,<sup>3</sup> other commentators had proposed antitrust remedies to cure any ills associated with PAEs.<sup>4</sup> Further, the study includes new data that are useful not only to add to our understanding of PAEs, but also to highlight questions for future research. Just a few of the interesting findings worth highlighting on both dimensions are:

- Litigation PAE patents had 80% more citations than the average patent, implying that PAEs are not litigating lower than average quality patents;

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<sup>2</sup> FED. TRADE COMM'N, PATENT ASSERTION ENTITY ACTIVITY 3-4 (2016) (dividing PAEs into two categories based on business model: Portfolio PAEs, which "contain[ed] hundreds or thousands of patents," and "negotiated licenses without first suing the alleged infringer," and Litigation PAEs, which "typically sued potential licensees and settled shortly afterward"), [https://www.ftc.gov/system/files/documents/reports/patent-assertion-entity-activity-ftc-study/p131203\\_patent\\_assertion\\_entity\\_activity\\_an\\_ftc\\_study\\_0.pdf](https://www.ftc.gov/system/files/documents/reports/patent-assertion-entity-activity-ftc-study/p131203_patent_assertion_entity_activity_an_ftc_study_0.pdf) [hereinafter PAE Study].

<sup>3</sup> Joshua D. Wright & Douglas H. Ginsburg, *Patent Assertion Entities and Antitrust: A Competition Cure for a Litigation Disease?*, 79 Antitrust L.J. 501 (2014) ("[T]here is surely a litigation problem layered on top of the more fundamental problem emanating from the PTO.").

<sup>4</sup> See Michael A. Carrier, *Patent Assertion Entities: Six Actions the Antitrust Agencies Can Take*, CPI Antitrust Chron., Winter 2013, Vol. 1, No. 2, at 1, 11–12; Ilene Knable Gotts & Scott Sher, *The Particular Antitrust Concerns with Patent Acquisitions*, Competition L. Int'l, Aug. 2012, at 30, 36; Mark S. Popofsky & Michael D. Laufert, *Antitrust Attacks on Patent Assertion Entities*, 79 Antitrust L.J. 445 (2014); Edith Ramirez, Chairman, Fed. Trade Comm'n, Opening Remarks Before the Computer & Communications Industry Association and American Antitrust Institute Program: Competition Law & Patent Assertion Entities: What Antitrust Enforcers Can Do (June 20, 2013), [www.ftc.gov/speeches/ramirez/130620paespeech.pdf](http://www.ftc.gov/speeches/ramirez/130620paespeech.pdf)

- 80% of firms that received one or more demand letters received only one such letter from a PAE;
- 77% of settlements by Litigation PAEs were under \$300,000, the approximate lower bound of discovery costs in patent litigation, while 65% of Portfolio PAEs' licenses generated more than \$1 million;
- Less than 1% of the patents in the study had been declared SEPs with RAND commitments; and
- For the 23% of cases that ended without a settlement, the result was generally either the defendant winning or the plaintiff withdrawing.

As the FTC correctly acknowledges, because the full population of PAEs is not identified in any publicly available data set, its results are based upon a potentially unrepresentative sample, making it inappropriate to extrapolate its findings to PAEs as a whole.<sup>5</sup> Curiously, however, the FTC goes on to do just that. Specifically, “based on the overall findings of this study,”<sup>6</sup> the FTC offers four policy recommendations to remedy “nuisance infringement litigation” that would necessarily apply to the entire population of PAEs—and beyond.<sup>7</sup>

First, the FTC recommends reforms to reduce discovery costs and mitigate PAEs' litigation advantages, including a revision of Federal Rule of Civil Procedure (FRCP) 26.<sup>8</sup> Second, the FTC recommends amending FRCP 7.1 to require more extensive disclosure of PAEs' related entities in order “[t]o provide defendants and the judiciary with a better understanding of financial relationships relating to firms that may appear in the courtroom.”<sup>9</sup> Third, the FTC recommends “enact[ing] provisions” to stay parallel proceedings against customers or end-users while litigation against the manufacturer is ongoing.<sup>10</sup> Finally, the FTC recommends that the courts “continue to consider the benefits of pleadings that provide sufficient notice to accused infringers” as they “continue to develop the plausibility standard in patent cases.”<sup>11</sup>

The descriptive content of the report, while informative, is neither necessary nor sufficient to support the FTC's four policy proposals. As an expert agency, the FTC has an obligation to meet the standard of care appropriate for making evidence-based policy recommendations. In our view, that standard requires some form of cost-benefit analysis. While some other agencies might

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<sup>5</sup> PAE STUDY, *supra* note 2, at F-2. *See also Id.* at F-12 (“this is a case study, and as such, it is not statistically valid to extrapolate the findings from the case study to the population of PAEs, manufacturers, or NPEs. Instead, the findings of the case study should be viewed as descriptive and probative for future studies seeking to explore the relationships between organizational form and assertion behavior.”).

<sup>6</sup> *Id.* at 12.

<sup>7</sup> *Id.* at 9.

<sup>8</sup> *Id.* at 10.

<sup>9</sup> *Id.* at 11.

<sup>10</sup> *Id.* at 12.

<sup>11</sup> *Id.* at 13.

lack the expertise to do this analysis, the FTC most certainly has it.<sup>12</sup> Offering unsubstantiated policy recommendations undermines the value of the descriptive contributions mentioned above. It also depreciates reputational capital built upon a long and proud tradition of analytical policy reports.<sup>13</sup> We do note, however, a trend at the FTC toward more frequent use of policy recommendations untethered from data or analysis or made without the benefit of any analysis at all.<sup>14</sup> Because it is unclear whether the policy recommendations in the FTC's PAE study would survive a cost-benefit test, and because they certainly cannot be substantiated based upon the PAE Study itself, we conclude the policy recommendations are in significant tension with the FTC's commitment not to extrapolate its findings to the population of all PAEs.

## I. The Study Does Not Support the FTC's Proposed Discovery Reforms

The FTC's recommendation to reduce discovery costs is intended to address the concern that defendants may settle even if they believe they have a high likelihood of winning on the merits because settlement is less costly than litigation.<sup>15</sup> The FTC attributes PAEs' success in achieving settlements to the severe asymmetry in discovery costs between PAEs and patent infringement litigation defendants. The FTC found that 77% of settlements by Litigation PAEs were under \$300,000, the approximate lower bound of discovery costs in patent litigation, while 65% of Portfolio PAEs' licenses generated more than \$1 million.<sup>16</sup> This finding implies that Portfolio PAEs seem to have stronger licenses, especially since they generate revenue well above the discovery cost threshold. Yet, the FTC also inferred that "discovery costs, and not the technological value of the patent, may set the benchmark for settlement value in Litigation PAE cases."<sup>17</sup> To lower the cost of discovery, and thus the settlement benchmark, the FTC recommends revising FRCP 26 to require earlier disclosure of claims, to limit discovery before preliminary motions, and to speed up decisions on such preliminary motions.<sup>18</sup> While the FTC's finding that several licenses of Litigation PAEs produced less than \$300,000 is interesting, nothing in the study supports the FTC's recommended discovery reforms.<sup>19</sup>

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<sup>12</sup> See Statement of Commissioner Joshua D. Wright, *On the FTC's Bureau of Economics, Independence, and Agency Performance* 5 (Aug. 6, 2015), [https://www.ftc.gov/system/files/documents/public\\_statements/695241/150806bestmtwright.pdf](https://www.ftc.gov/system/files/documents/public_statements/695241/150806bestmtwright.pdf) ("BE staff economists . . . have rightfully earned a reputation as highly skilled and independent analysts within the FTC.").

<sup>13</sup> See, e.g., FED. TRADE COMM'N, CIGARETTE REPORT FOR 2011 (2013); FED. TRADE COMM'N, BROADBAND CONNECTIVITY COMPETITION POLICY (2007); FED. TRADE COMM'N, POSSIBLE ANTITRUST COMPETITIVE BARRIERS TO E-COMMERCE: WINE (2003).

<sup>14</sup> See Dissenting Statement of Commissioner Joshua D. Wright, *Issuance of The Internet of Things: Privacy and Security in a Connected World Staff Report* (Jan. 27, 2015), [https://www.ftc.gov/system/files/documents/public\\_statements/620701/150127iotjdwstmt.pdf](https://www.ftc.gov/system/files/documents/public_statements/620701/150127iotjdwstmt.pdf) (dissenting from the Commission's decision because the recommendations lacked analytical support).

<sup>15</sup> PAE STUDY, *supra* note 1, at 20, 90.

<sup>16</sup> *Id.* at 90-91.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 10, 11.

<sup>19</sup> *Id.* at 89-92.

The FTC's study acknowledges that lawmakers have raised this policy recommendation before; and bills introduced in Congress have already addressed staying discovery during certain preliminary motions.<sup>20</sup> Further, the study does not tell us whether the Supreme Court's more recent decisions in *Highmark* and *Octane Fitness*, which lower the standard to obtain fees under 35 U.S.C. § 285, are sufficient to address these concerns.<sup>21</sup> We do know, however, that district courts have awarded fees to defendants in patent infringement suits under *Highmark* and *Octane Fitness* for cases that are "objectively baseless," and for patent misuse.<sup>22</sup>

Further, that a majority of settlements are less than \$300,000 is not evidence that the patent suits should be categorized as nuisance litigation. As we have noted elsewhere, PAEs are not the first plaintiffs to take advantage of our legal system by bringing or threatening to bring cases purely for their settlement value.<sup>23</sup> Notably, most infringement claims asserted by PAEs have involved a computer software patent.<sup>24</sup> This phenomenon can be traced to the United States Patent and Trademark Office's issuance of questionable patents for software, which raises "the degree of actual uncertainty attending the patents upon which PAEs base their claims" and therefore increases the defendant's expected litigation cost.<sup>25</sup>

The FTC does point to areas where further research may be necessary. For example, with respect to the question whether cases brought by PAEs are weak, the study states that cases ending without a settlement (23%) generally resulted in either the defendant winning or the plaintiff withdrawing.<sup>26</sup> This could indicate that if defendants choose to fight cases instead of settling, they are likely to prevail, or, instead, that defendants fight only cases they are likely to win. The data in the study, however, do not allow us to predict how—or, indeed, whether—the FTC's proposed discovery reforms would affect PAE behavior.

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<sup>20</sup> *Id.* at 33.

<sup>21</sup> See *Highmark Inc. v. Allcare Health Mgmt. Sys.*, 134 S. Ct. 1744 (2014); *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749 (2014). See also PAE STUDY, *supra* note 1, at 70.

<sup>22</sup> Kat Greene, *Supplement Cos. Seek Fees From 'Patent Troll' ThermoLife*, LAW360 (Oct. 13, 2016) (asserting an invalid patent), <http://www.law360.com/articles/851001/supplement-cos-seek-fees-from-patent-troll-thermolife>. Additionally, a recent empirical study found that attorney' fees awards have increased post-*Octane Fitness*, especially in favor of defendants. See Scott M. Flanz, *Octane Fitness: The Shifting of Patent Attorneys' Fees Moves into High Gear*, 19 STAN. TECH. L. REV. 329, 358 & 361 (2016).

<sup>23</sup> Wright & Ginsburg, *supra* note 2 at 501, 516 ("The rise of PAEs, however, does not mark the first time lawyers have found a way to profit from bringing or threatening to bring cases purely for their settlement value. Indeed, this has been a recurring problem, though it has arisen in a variety of otherwise unrelated types of litigation. In each such instance lawmakers have responded by adjusting the procedural framework in order to take the profit out of the new form of abusive litigation.").

<sup>24</sup> Colleen Chien & Aashish Karkhanis, Presentation at the Patent and Trademark Office Software Partnership Roundtable at Stanford University: Software Patents & Functional Claiming 6 (Feb. 12, 2013), [www.uspto.gov/patents/init\\_events/software\\_ak\\_cc\\_sw.pdf](http://www.uspto.gov/patents/init_events/software_ak_cc_sw.pdf); PAE STUDY, *supra* note 1, at 135-36 (recognizing that *Alice Corp. v. CLS Bank International*, 134 S. Ct. 2347 (2014), which suggests many computer software based patents are invalid, may affect the findings of the study since the FTC did not collect enough information post-*Alice* to measure its impact on PAE activity; *Alice* is particularly significant to the FTC's study given that approximately 73% of sampled patents related to software claims).

<sup>25</sup> Wright & Ginsburg, *supra* note 2, at 518-19.

<sup>26</sup> PAE STUDY, *supra* note 1, at 70.

## II. The Study Does Not Support Concern About the Transparency of PAEs' Structure

The FTC's second recommendation is intended to address concerns about the transparency of PAEs' complex entity structure by adding to the disclosures already required under FRCP 7.1.<sup>27</sup> The FTC claims expanding the reportable relationships under FRCP 7.1 to require parties to "list all persons . . . that may have a pecuniary interest in the outcome of the case," would benefit both defendants and the judiciary.<sup>28</sup> With respect to defendants' interests, the FTC argues that lack of transparency may prevent defendants from recognizing that they already have a license from a related entity. The FTC's observations about the "transparency issues with multi-affiliate structures," however, are entirely theoretical, indeed speculative; are not factually supported by anything in the study.<sup>29</sup>

The FTC further argues that the complex structure of some PAEs may hinder a defendant's negotiations when a defendant receives multiple demand letters from entities it does not realize are related. Here the data in the study actually counter-indicate the FTC's recommendation: The FTC found that 80% of firms that received demand letters received only one such letter from a PAE.<sup>30</sup>

As to how the judiciary would benefit from increased disclosures concerning entity structures, the Study is uninformative. As the FTC notes, FRCP 7.1 is meant to inform judges of conflicts of interest so they can recuse themselves. But there is no indication in the report that a single conflict has been overlooked in patent cases under the current rule. Of course, it is possible that a conflict went unnoticed and therefore unreported, but in that case the judge could not have been biased by a conflict of which he or she was unaware. Because disclosure is not costless, this recommendation is unlikely to pass a cost-benefit test. In any event, it is not factually supported by the study.

## III. The Study Does Not Support Concerns About Parallel Litigation

The FTC's third recommendation addresses its concern about parallel, i.e., duplicative, patent infringement litigation going forward simultaneously against both the manufacturer and one or more end users of the same allegedly infringing device. The specific recommendation is for Congress and the Judicial Committee to adopt procedures that encourage courts to stay actions against end users when the manufacturer is also being sued until the manufacturer's suit is resolved.<sup>31</sup>

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<sup>27</sup> *Id.* at 11. Rule 7.1 provides: "A nongovernmental corporate party must file 2 copies of a disclosure statement that: (1) identifies any parent corporation and any publicly held corporation owning 10% or more of its stock; or (2) states that there is no such corporation."

<sup>28</sup> *Id.* at B-13 n.385 (quoting N.D. CAL. CIV. L.R. 7.1-1).

<sup>29</sup> *Id.* at 52.

<sup>30</sup> *Id.* at 62-63.

<sup>31</sup> *Id.* at 12.

Other than showing that “a significant portion” of defendants—15% for cases brought by Litigation PAEs—are end-users rather than manufacturers, the study does not provide any factual support for the FTC’s recommendation for preventing parallel litigation by a PAE against both the manufacturer and end-users.<sup>32</sup> That is, the study does not identify a single instance in which parallel infringement cases went forward against a manufacturer and an end user of its product. Even the evidence that 15% of defendants are end-users is suspect when extrapolated to all PAEs, given the FTC’s acknowledgement of the study’s limitations. Consequently, this recommendation could have been drawn out of existing policy discussions, including the hearings related to the Innovation Act, a bill introduced in the United States House of Representatives in 2015 that addresses staying litigation against end-users.<sup>33</sup>

#### **IV. The Study Does Not Support Its Recommendation Regarding Pleading Standards**

The FTC’s fourth and most curious recommendation was intended to address pleadings standards for federal court litigation as they relate to patent law cases: The agency recommends that federal courts hearing patent cases develop the law with regard to the “plausibility” pleading standard newly applicable in all federal litigation.<sup>34</sup> With this recommendation, the FTC encourages courts to recognize the benefits provided to accused infringers by fuller notice of the claim being made. This is, of course, the ordinary role of the courts and, recommendation or not, courts could not fail to do this in the ordinary course. The FTC’s recommendation is analogous to advising rivers to run downhill.

#### **V. Conclusion**

The FTC’s study was not designed to serve as a basis for policy recommendations and, as we have seen, is neither necessary nor sufficient to support any of its suggestions. The four policy recommendations are not even purportedly linked to the study and should not serve as a basis for litigation, regulation, or law enforcement initiatives. We can only hope the FTC, in future exercises of its 6(b) authority, will avoid making policy recommendations insufficiently substantiated by data and analysis.

That said, the present study does make important descriptive contributions that are worthy of the attention of economists, courts, legal scholars, and policymakers. Measured on that dimension, the PAE Study can claim some modest success. The PAE Study does support one important policy implication: The study makes clear that PAEs’ behavior is not a competition problem worthy of an antitrust remedy but rather a problem that requires a remedy focused upon procedure and litigation.

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<sup>32</sup> *Id.* at 12, 99-100.

<sup>33</sup> *Id.* at 33.

<sup>34</sup> *Id.* at 12.

# The FTC Report on Patent Assertion Entities: Lifting the Veil

By Robin Feldman<sup>1</sup>

The FTC this month released its Section 6(b) study on Patent Assertion Entity Activity. Section 6(b) studies are rare, but have played key roles in shaping federal legislation and national economic policy.<sup>2</sup> The Study has been eagerly awaited and certainly lives up to its promise. It is a thoughtful and thorough document (not just because the Agency was kind enough to cite my work).

Definitions are a key battleground in the analysis of modern patent assertion.<sup>3</sup> The FTC focuses on patent assertion entities (PAEs), which the Agency defines as businesses that acquire patents from third parties and generate revenue by asserting them against alleged infringers through licensing negotiations, litigation, or both. The definition encompasses much important activity, but leaves some out, such as failed entrepreneurs who turn to patent assertion as a second career, and patent attorneys who author business method patents for purposes of assertion.

The Agency further separates PAEs into two categories: 1) Portfolio PAEs, who negotiate licenses covering hundreds or thousands of patents, frequently without initiating litigation, and 2) Litigation PAEs, who typically sue potential licensees and settle shortly afterwards by granting licenses covering small portfolios for royalties below \$300,000.

In addition to numerous details of interest, the Study contains three critical observations. First, with 77% of settlements valued below the cost of defending a lawsuit through discovery, the Agency concludes that, “the behavior of Litigation PAEs is consistent with nuisance settlements.” Thus, while the Agency recognizes the importance of protecting patent rights, the Study demonstrates that, at least for Litigation PAEs, the business model is a nuisance one.

I note that the FTC and the DOJ recently proposed an update to their 1995 IP Licensing Guidelines, which continues to assert that licensing is generally pro-competitive.<sup>4</sup> The PAE Study suggests that this generality may need refinement.

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<sup>1</sup> Harry & Lillian Hastings Professor and Director of the Institute for Innovation Law, University of California Hastings Law.

<sup>2</sup> For additional details on § 6(b) and its history, see Robin Feldman, *Intellectual Property Wrongs*, 18 STAN. J.L. BUS. & FIN. 250, 313-317 (2013) (arguing that the FTC should initiate a § 6(b) investigation into modern patent assertion and monetization).

<sup>3</sup> See Robin Feldman, *Patent Demands & Startup Companies*, 16 YALE J.L. & TECH. 236, 244-254 (2014) (analyzing various definitions).

<sup>4</sup> U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, PROPOSED UPDATE TO ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (Aug. 12, 2016).



Second, the money is with the big guys. The 22 PAEs in the Study brought in \$3.2 billion in reported revenue, and 80% of that money went to the Portfolio PAEs. Litigation PAEs may be easier to spot as nuisances, but Portfolio PAEs have the greatest economic impact. This is particularly important given that Portfolio PAE licenses cover large numbers of patents and may contain field-of-use restrictions. Both facts should pique the interest of competition authorities. An entity could acquire market power without a monopoly on relevant patents simply by deploying a large enough group of random patents together with a reputation for tough tactics.<sup>5</sup> In addition, field-of-use restrictions raise the specter that Portfolio PAEs could serve as the hub for a hub-and-spokes horizontal arrangement.<sup>6</sup> Finally, royalties for the same patents in the same industry vary greatly, suggesting that something other than patent value is operating.

The third critical observation is the role software patents play in PAE behavior. More than three-quarters of the patents asserted by PAEs in this Study are software-related. This demonstrates, yet again, that many modern patent assertion troubles can be laid at the feet of the Federal Circuit, with its encouragement of broad, nonspecific language for software patents.<sup>7</sup> It is also a reminder of the importance of ensuring that courts properly apply the *Alice*<sup>8</sup> standard enunciated by the Supreme Court to reduce this behavior.

The Study also suggests some widely discussed anecdotes are not generalizable, finding that: 1) fewer than 1% of patents were essential to a standard, 2) although ownership transparency is important for negotiating settlements and rights to future-acquired patents, demands from multiple affiliates are uncommon, and 3) most demands are litigated, so litigation provides viable data, if information is not sealed.

There are disappointments in the study. The FTC notes that diverse record-keeping practices meant the Agency could not show how much revenue PAEs share with inventors or the costs of assertion. These are important pieces of the economic puzzle. And it is somewhat odd that the Agency uses data from RPX, a Portfolio PAE itself, to decide which PAEs to include in the Study.<sup>9</sup> This seems an uncomfortable conflict of interest, although buy-in from the entities studied may have encouraged cooperation.

From that perspective, a subsection analyzing the wireless chip industry is an inspired political choice. This section includes assertion behavior by manufacturers and by non-practicing entities (NPEs), defined as those who seek to develop and transfer technology—apparently

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<sup>5</sup> See Feldman, *Intellectual Property Wrongs*, *supra* note 2, at 304-306.

<sup>6</sup> For a description of Portfolio PAEs as hub-and-spokes, and acquiring market power without a monopoly on relevant patents, see Robin Feldman, *Exceptions to the Rule*, 26 COMPETITION: THE JOURNAL OF THE ANTITRUST AND UNFAIR COMPETITION LAW SECTION OF THE STATE BAR OF CALIFORNIA (forthcoming 2016); Feldman, *Intellectual Property Wrongs*, *supra* note 2.

<sup>7</sup> See ROBIN FELDMAN, RETHINKING PATENT LAW 91-135 (2012).

<sup>8</sup> *Alice Corp. v. CLS Bank Int'l*, 573 U.S. \_\_\_, 134 S. Ct. 2347 (2014).

<sup>9</sup> See PAE STUDY at 38, n. 55.

universities and semiconductor chip designers.<sup>10</sup> Both players have been adamant that they should be excluded from patent reform.

The section concludes that manufacturers behave more like Portfolio PAEs, although the avenues of comparison are limited. NPE behavior varies, with some behaving like Litigation PAEs and some like Portfolio PAEs. The moral of the story is that no one necessarily wears a white hat. When universities and semiconductor companies behave in an anticompetitive or nuisance manner, they should be held accountable. The same is true for manufacturers.

In short, the Study suggests there is much work ahead for competition agencies and legislators. It also confirms, in a careful and reliable manner, what many in the industry have been complaining vociferously about for some time.

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<sup>10</sup> See PAE STUDY at Appendix A, n. 350 (referencing prior definitions).

# Patent Assertion Entity Activity: An FTC Study Comments of a Study Participant

By Scott W. Burt<sup>11</sup>

Conversant Intellectual Property Management Inc.<sup>12</sup> participated in the Federal Trade Commission's study of patent assertions entity (PAE) activity.<sup>13</sup> Conversant welcomed the FTC study precisely because, as Commissioner Maureen Ohlhausen recently put it, prior discussions of PAEs "have been light on facts and heavy on aspersions".<sup>14</sup> Conversant believed that only this kind of deeper analysis by an impartial body would put to rest the "patent troll" label applied to professional patent licensing companies. Indeed, the FTC Study recognized the core distinction in PAE business models between what it terms "Litigation PAEs" and "Portfolio PAEs". According to the FTC's definitions, Conversant is characterized as a "Portfolio PAE"<sup>15</sup> that it recognizes may perform an efficient function of patent aggregation and portfolio licensing.

## Conversant's Background

Conversant is a 41-year-old technology company founded in 1975 as a designer of semiconductor DRAM memory chips. By the 1990s, Conversant's innovative, patented DRAM technology had been widely adopted, but mostly without permission. The company responded by actively and successfully licensing its DRAM patent portfolio. Over time, Conversant focused increasingly on IP management as a way to capitalize on its patenting and licensing expertise. While Conversant continues to obtain patents from its legacy of memory research and development, most of Conversant's roughly 3,000 patent portfolio has been the result of patent acquisitions, many from innovators who have concluded that Conversant could more efficiently license or enforce those patent rights.

Today Conversant is a patent licensing company that, as the FTC study notes, "most closely resemble[s] the licensing arms of manufacturing firms."<sup>16</sup> Conversant is committed to responsible

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<sup>11</sup> Senior Vice President, Chief Intellectual Property Officer & General Counsel, Conversant Intellectual Property Management.

<sup>12</sup> See Conversant Intellectual Property Management Inc. site at <http://www.conversantip.com>.

<sup>13</sup> Federal Trade Commission, *Patent Assertion Entity Activity: An FTC Study* (Oct. 2016) ("PAE STUDY"), at <https://www.ftc.gov/reports/patent-assertion-entity-activity-ftc-study>.

<sup>14</sup> Maureen K. Ohlhausen, *The FTC PAE Study in Context, Remarks at the Technology Policy Institute*, Washington, D.C. (Oct. 20, 2016), <https://www.ftc.gov/public-statements/2016/10/prepared-remarks-commissioner-maureen-k-ohlhausen-ftc-pae-study-context> at 1.

<sup>15</sup> "Portfolio PAEs negotiated licenses covering large portfolios, often containing hundreds or thousands of patents, frequently without first suing the alleged infringer." PAE STUDY at 3. Conversant's research and development prior to and during the 2009-2014 study period also would make it an NPE ("Non-practicing entity" or 'NPE' means patent owners that primarily seek to develop and transfer technology." PAE STUDY at A-2.), except that Conversant's technology development has been in memory chips, not the wireless chipsets at issue in the study.

<sup>16</sup> PAE STUDY at 45.

Patent Licensing Principles<sup>17</sup>, which the company developed in 2013 and which align with the four recommendations of the FTC study.<sup>18</sup>

### The FTC Study Confirms That Patent Licensing Companies Behave Differently From Patent Litigation Entities

The FTC carefully points out that it conducted a “case study, not a statistical sampling that tests hypotheses about the full universe of PAEs”.<sup>19</sup> Yet even within the limitations of its case study, “the standout conclusion was that **there is no one PAE business model**. Rather, **a glaring distinction exists** between Portfolio PAEs, on the one hand, and Litigation PAEs, on the other.”<sup>20</sup> According to the FTC’s definitions, of the 22 PAEs<sup>21</sup> in the study, Conversant is one of the four “Portfolio PAEs.”<sup>22</sup>

The FTC observed that Portfolio PAEs like Conversant “most closely resembled the licensing arms of manufacturing firms”<sup>23</sup> that seek to negotiate portfolio licenses without resort to litigation:

Portfolio PAEs generally reached licensing commitments without bringing litigation against a potential licensee ... In lieu of litigation, licensing executives hired by Portfolio PAEs

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<sup>17</sup> Conversant Intellectual Property Management Inc., Patent Licensing Principles (Nov. 2013), <http://www.conversantip.com/wp-content/uploads/Conversant-Patent-Licensing-Principles.pdf>.

<sup>18</sup> See *id.*, Principle 9, “A licensor should initiate litigation only for the purpose of obtaining appropriate compensation for the use of its patented technology, or that of a related portfolio of patents, and never for the purpose of achieving a nuisance or litigation-cost-based settlement,” aligns with the FTC’s first recommendation to examine discovery costs to minimize the ability of some Litigation PAEs to seek nuisance settlements. PAE STUDY at 9-11. Principle 1, “A patent’s true, direct ownership should always be disclosed and never hidden behind shell or sham companies,” aligns with the FTC’s second recommendation to consider changes to the party disclosure requirements of Federal Rule P. 7.1 to deal with a lack of transparency among some Litigation PAEs. PAE STUDY at 11. Principle 4, “Although a licensor is by law free to license anywhere in a chain of distribution, a responsible licensor generally should not seek licenses from or threaten litigation against a business such as a start-up company, a local retailer or a small end-user customer unless it directly competes against the licensor,” aligns with the FTC’s third recommendation to consider ways to protect retailers from inappropriate suits by Litigation PAEs. PAE STUDY at 12. Finally, Principle 3 (relating to licensing negotiations that usually should precede any litigation), “The licensor should be willing to provide documented evidence of use, including claim charts, to the licensee for its review,” aligns with the FTC’s final recommendation to consider ways to provide early notice of the basis of infringement claims by Litigation PAEs. PAE STUDY at 12.

<sup>19</sup> Ohlhausen at 11. See, e.g., PAE STUDY at E-4 (“The proposed study has two components: (1) a case study of 25 PAEs reflecting different types of PAE business models ...”).

<sup>20</sup> Ohlhausen at 11 (emphasis added). See PAE STUDY at 42.

<sup>21</sup> PAE STUDY at 2.

<sup>22</sup> “Portfolio PAEs negotiated licenses covering large portfolios, often containing hundreds or thousands of patents, frequently without first suing the alleged infringer.” PAE STUDY at 3. Conversant’s research and development prior to and during the 2009-2014 study period also would make it an NPE (“‘Non-practicing entity’ or ‘NPE’ means patent owners that primarily seek to develop and transfer technology.” PAE STUDY at A-2.), except that Conversant’s technology development has been in memory chips, not the wireless chipsets at issue in the study.

<sup>23</sup> PAE STUDY at 45.

typically began negotiations by reaching out to a large network of contacts and offering a portfolio license.<sup>24</sup>

As specialized patent licensing companies, Portfolio PAEs are part of the complex and evolving intellectual property development, licensing, and implementation ecosystem that is developing new business models and new markets for intellectual property.

Commissioner Ohlhausen recognized the potential market benefits of specialist patent licensing companies in recent remarks:

All told, Portfolio PAEs engage in conduct that is potentially consistent with an efficient aggregation service. Given the sums that change hands in arms-length transactions between Portfolio PAEs and their licensees – amounts that seem often to exceed the cost of litigation – it appears that technology users paid sums that may reflect the quality of the licensed patents. Furthermore, in aggregating thousands of presumably complementary patents into a single source, Portfolio PAEs may alleviate royalty-stacking effects associated with divided ownership of complementary property rights.<sup>25</sup>

Portfolio PAEs play a valuable role, especially in a world where the companies that perform the technological research and development, make the innovation, and own the resulting patent portfolios may no longer be the same companies that implement that technology. Not every inventor need engage in the type of self-help that characterized Conversant's own evolution in order to reap the rewards from its innovations. Portfolio PAEs provide an efficient connection between technology innovators and implementing licensees to reward and incentivize the innovative activity.<sup>26</sup>

Litigation PAEs, on the other hand, typically pursue sue-and-settle behavior. Few licenses are concluded in the absence of litigation and their relatively early and low-dollar settlements led the FTC to conclude that “the behavior of Litigation PAEs is consistent with nuisance litigation”.<sup>27</sup>

The FTC recognizes in its study that a label can be “unhelpful because it invites pre-judgment about the societal impact of patent assertion activity without an understanding of the underlying business model that fuels such activity”.<sup>28</sup> Its own study shows that it is time to shed

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<sup>24</sup> PAE STUDY at 46.

<sup>25</sup> Ohlhausen at 12.

<sup>26</sup> See Ohlhausen at 6-7 (“There was – and perhaps is – a disconnect between upstream inventors and the downstream manufacturers that sell technological products to consumers. If an intermediary were to emerge that efficiently bridged the gap between patentees and technology users, it could bring new solutions and functionality to manufacturers while rewarding patentees and encouraging further innovation.”).

<sup>27</sup> PAE STUDY at 4. Because the FTC study did not examine the circumstance of any particular case, some commentators have pointed out that the study cannot unequivocally support the view that this is all nuisance litigation as opposed to low-value litigation. See Michael Risch, *The Long Awaited FTC Study on Patent Assertion and Nuisance Litigation*, Post in the Written Description blog, (Oct. 6, 2016), <http://writtendescription.blogspot.ca/2016/10/the-long-awaited-ftc-study-on-patent-6.html>.

<sup>28</sup> PAE STUDY at 13 (discussing the pejorative “patent troll”).

the unhelpful and overbroad “PAE” label once and for all when talking about particular behaviors and policies directed at those behaviors. To do otherwise would risk elevating form over substance and burying the “glaring distinction” that was a central finding of the report.

### **The FTC’s Policy Recommendations – Directed at Patent Litigation Entities – Should Be Considered in the Context of the Multi-Billion-Dollar Patent Licensing Industry Represented by the Patent Licensing Companies**

In its study the FTC offers four recommendations for legislative and judicial reform.<sup>29</sup> These recommendations all are aimed at patent litigation entities (Litigation PAEs) and their behavior found consistent with nuisance litigation.<sup>30</sup> The FTC recognizes that “infringement litigation plays an important role in protecting patent rights, and that a robust judicial system promotes respect for the patent laws,” offering its recommendations as a “balance” between the need to protect patent rights through patent litigation and the problems caused by nuisance-litigation behavior.<sup>31</sup> In striking that balance, Conversant urges policymakers to carefully weigh the interests of patent licensing companies, including both the Portfolio PAEs in the study and the “licensing arms of manufacturing firms”<sup>32</sup> to which they compare.

The numbers in the FTC study itself show the relative size of the interests. The 18 patent litigation entities studied filed 96% of the cases, but generated only 20% of the measured revenue, amounting to \$800 million from 2009 to 2014.<sup>33</sup> The four patent licensing companies, by contrast, litigated rarely, yet their licensing activities resulted in high-value licenses that generated \$3.2 billion during that period.<sup>34</sup> The licensing activities of those four patent licensing companies in the study, moreover, make up only a small part of the overall patent licensing industry. The annual revenues generated by patent licensing in the United States are estimated to exceed \$150 billion,<sup>35</sup> an amount approaching \$1 trillion over the study period – about 1,000 times the revenues of the patent litigation entities studied.

While there would seem to be little objection towards efforts to reduce the burdens associated with “nuisance litigation,” in the pursuit of this worthy goal, we must be careful not to do disproportionate harm to legitimate interests. Any change to the patent litigation system that

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<sup>29</sup> PAE STUDY at 8-13. Some commentators find a “disconnect” between the study and its recommendations. See Michael Macagnone, *DC Circ. Judge Challenges FTC Patent Study Suggestions*, Law360 (Oct. 13, 2016), <http://www.law360.com/articles/851324/dc-circ-judge-challenges-ftc-patent-study-suggestions> (quoting D.C. Circuit Judge Douglas Ginsburg, “The study is neither sufficient nor necessary to support the recommendations, some of which are worth consideration or implementation on their own. There is simply a logical disconnect between the study and the recommendations.”).

<sup>30</sup> PAE STUDY at 8-9 (introductory paragraph to recommendations solely discussing Litigation PAEs).

<sup>31</sup> PAE STUDY at 9.

<sup>32</sup> PAE STUDY at 45.

<sup>33</sup> PAE STUDY at 4.

<sup>34</sup> PAE STUDY at 3.

<sup>35</sup> See Yuichi Watanabe, Note, *Patent Licensing and the Emergence of a New Patent Market*, 2009 Hous. Bus. & Tax J. 445, 449 n.24.

make patents harder and more expensive to enforce risks devaluing the patent assets that underlie those licenses, and that in turn may have a direct impact on the overall patent licensing industry and the innovative activity that it supports.

# Theory versus Evidence: A Cautionary Tale for Interpreting the FTC’s 6(b) PAE Study

By Anne Layne-Farrar<sup>1</sup>

The FTC’s long-awaited 6(b) study on Patent Assertion Entities (PAEs) provides an intriguing view into the business operations of litigation-oriented PAEs. Through the study, we learn where such PAEs obtain their patents (50% buy patents from individual inventors or from those inventors’ employers); the kinds of patents they acquire (88% fall into Computers & Communications or Other Electrical & Electronic technology categories and 75% include software-related claims); and how they assert those patents (the majority file patent infringement litigation and then settle quickly for payments averaging around \$300,000).

To fully understand the findings in the PAE report, however, we need to understand how the study was constructed. In particular, understanding who the FTC did and did not interview has crucial implications for both the study’s results and the FTC’s policy reform recommendations. In this brief note, I highlight some important elements of the FTC’s study methodology and the impact that methodology has on interpreting the PAE report.

Consider first how the FTC identified the PAE respondents to which it sent its queries. The Commission relied on data from RPX, a for-profit patent defense company that has created a database on NPE patents.<sup>2</sup> RPX acquires patents that NPEs assert in litigation and then offers licenses to those patents to its members. The proprietary RPX database is therefore litigation-oriented. As a result, the bulk of the FTC’s respondents identified through the RPX database – 18 of the total 22 PAEs included – are classified by the FTC as “Litigation PAEs.” The other 4 PAE respondents are what the FTC refers to as “Portfolio PAEs,” entities that assert their patents in infringement litigation far less often and who instead typically negotiate patent licenses without filing an infringement lawsuit. The nature of the RPX database means the FTC has far more respondents, and thus far more information, on PAEs with a litigation strategy as opposed to a licensing strategy. We do not know what proportion of the overall PAE universe (something no one has been able to define yet) is comprised of Litigation PAEs as compared to Portfolio PAEs. Nor do we know if other non-litigating PAE business models exist aside from Portfolio PAEs. As the FTC report acknowledges, the Commission found no evidence at all of patent assertion entities sending low-revenue demand letters to large numbers of end users without filing a patent infringement suit, along the lines of MPHJ Technology Investments, the firm that the FTC settled

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<sup>2</sup> See <https://www.rpxcorp.com/>.



with over deceptive demand letter practices in 2015.<sup>3</sup> Because the RPX data source focuses on litigation, it is unclear if firms like MPHJ are relatively rare or simply not included in the study.

Second, consider who the FTC did *not* include in its PAE study. In addition to the extremely limited coverage of PAEs not focused on litigation (only 4 of the 22 PAE respondents), the study includes no patent licensees and no patent infringement defendants. That is, the study examines the conduct of just one side of the patent transaction, be it litigation or licensing. While the FTC did ask for limited information on which firms the respondent PAEs were licensing and/or suing (the common answer being Computer and Electronics manufacturing firms for both Litigation and Portfolio PAEs), this is the extent of the information that the study provides on the recipients of PAE patent assertions. As a result, the report cannot offer any insight into how patent assertion recipients respond to PAE assertions, whether the potential costs imposed by Litigation PAE lawsuit tactics differ significantly from the costs imposed by other kinds of patent plaintiffs, nor whether trial discovery efforts imposed by PAE plaintiffs impose greater burdens on defendants than those imposed by non-PAE plaintiffs.

These two aspects of the FTC's methodology for the PAE 6(b) study – a bias toward PAEs who emphasize litigation over licensing and a one-sided view of that litigation – also have important implications for assessing the FTC's policy reform recommendations. In particular, the study posits that Litigation PAEs must be using nuisance litigation to extort settlements because Litigation PAEs sue first without attempting arm's length negotiations, settle quickly, and do so for roughly the cost of litigation discovery. On this basis, the FTC then recommends four policy reforms focused on the early stages of litigation: increasing pleading requirements, increasing reporting requirements for non-parties of interest, balancing asymmetric discovery burdens, and staying litigation against non-manufacturers when multiple suits are filed on the same patents. While one can certainly debate the merits of any of these four reforms – all of which have appeared in legislative proposals in recent years – the FTC study offers no evidence in support of any of them. The study does not delve into patent infringement pleading requirements or whether they are currently insufficient. The study does not investigate whether PAE lawsuit defendants are hampered in any way by not having full and complete information on all PAE parties of interest. The study does not assess whether discovery burdens are particularly asymmetric for PAE lawsuit defendants as compared to defendants in other NPE or non-NPE litigations, nor does it explain why such asymmetries would need to be corrected by legislation when unaddressed asymmetries of other sorts are common in litigation in general. Finally, the study does not examine whether judges are failing to exercise their current capacity to stay cases appropriately when multiple suits are filed on the same patents against multiple defendants, particularly in protection of end consumers.

In summary, the FTC presents novel findings on PAEs that focus on litigation, expanding our knowledge of this particular form of PAE. But it does not do more than this. Importantly, the study did not explore litigation practices and costs, and as such, the patent policy reforms presented by the study are not supported by its results. Finally, the proposals that are made do

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<sup>3</sup> Press Release, Federal Trade Commission, *FTC Approves Final Order Barring Patent Assertion Entity From Using Deceptive Tactics* (March 17, 2016), <https://www.ftc.gov/news-events/press-releases/2015/03/ftc-approves-final-order-barring-patent-assertion-entity-using>.

not target the Litigation PAEs that are the focus of the study, but instead would apply to patent litigation generally. As such, the study's recommendations are likely to have undesired, unintended consequences.

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