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The innovation costs of a flawed patent system

Scott Sher and Kara Kuritz of Wilson Sonsini Goodrich & Rosati examine the patent-law implications of recent technology cases attracting US regulatory scrutiny



Scott Sher

Scott Sher is a partner at Wilson Sonsini Goodrich & Rosati's Washington office, where his practice focuses on antitrust counselling and litigation. He represents technology clients in connection with antitrust issues that arise throughout the merger and acquisition process, from pre-merger counselling through investigations conducted by the Department of Justice, the Federal Trade Commission and foreign regulatory agencies.



Kara Kuritz

Kara Kuritz is an associate in the Washington office of Wilson Sonsini Goodrich & Rosati, where she is a member of the antitrust practice. While in law school, Kara spent two years as a law clerk at the Federal Trade Commission, working in the Mergers IV division. She is a member of the Bar of the District of Columbia and of the State Bar of New York.

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Introduction

If recent events are any indication, the use of patents as “nuclear warfare” among companies in the technology industry is unlikely to end soon. Under the current market dynamics, for a company to be able to compete in high-tech industries such as operating systems or mobile devices, it must have a large patent portfolio to enable it defend itself against the inevitable lawsuits that competitors bring to impose a significant tax or ultimately prevent the entry of new products on the market. Without the ability to bring about “mutually assured destruction,” a company has no way to defend itself in costly patent litigation. The problem is exacerbated because, as one commentator put it, “ridiculous, broad, meaningless patents get approved all the time.”¹ In 2010, the US Patent and Trademark Office approved a record 244,341 patents, up 27 percent from 2009.² These patents are being sought not to encourage innovation, but as a means to prevent it.

The Federal Trade Commission (FTC), in a report published in March of this year, recognised that competition is distorted when patents are transferred as assets whose value is based on the ability to extract rents from companies that have already implemented the technology.³ Contrary to the intent behind the patent system, the current system involving patent battles among competitors produces *less* competition and innovation:

- Small startups get sued for patent infringement before bringing their products to market, and either cannot bring their products to market, are delayed in bringing their products to market, can only bring their products to market at higher prices, or must be bought by a larger competitor with a large patent portfolio to bring their products to market;
- The offering and adoption of open-source alternatives is stifled because companies implementing open-source technology fear patent claims;

- Large companies spend billions of dollars of patent acquisition and litigation rather than on bringing new products to market; and
- Consumers are faced with higher prices and less choice because new products either never make it to market or make it only after significant delay.

An even more troubling trend for antitrust regulators is the rise of competitors joining together to purchase patent portfolios. On one side, these consortiums argue that allowing the companies to come together to purchase these patents allows them to cross-license the patents among them and ensure that none are sued for infringing the patents. Conversely, companies left out of the consortium are deprived of any means of defending themselves against the group’s assertion of their patents. Two recent patent acquisitions by group consortiums of competitors shed light on this trend: 1) CPTN Holdings LLC’s (“CPTN”) acquisition of Novell Inc.’s (“Novell”) patents, and 2) Rockstar Bideo’s (“Rockstar”) 4.5 billion-dollar bid for Nortel Networks’ (“Nortel”) patents after the company filed for bankruptcy earlier this year.

Legal and Statutory Framework. It is important to understand first the statutory and regulatory principles under which such transactions are reviewed. The Department of Justice (DOJ) and the FTC have expressly stated, “[t]he Agencies apply the same general antitrust principles to conduct involving intellectual property that they apply to conduct involving any other form of tangible or intangible property.”⁴ And while it is true that patents confer a statutory right to exclude others from the use of a given technology:

An intellectual property owner’s rights to exclude are similar to the rights enjoyed by owners of other forms of private property. As with other forms of private property, certain types of conduct with respect to intellectual property may have anticompetitive effects against which the antitrust laws can and do protect. Intellectual property is thus neither

*particularly free from scrutiny under the antitrust laws, nor particularly suspect under them.*⁵

Thus, the purchase of intellectual property rights (including patents), where such acquisition would tend to enhance or entrench the purchaser’s market power in a properly defined relevant market, is one such example of anticompetitive conduct involving intellectual property that can, and has, justified enforcement activity by the DOJ.

It also is axiomatic that competitors cannot band together to exclude another competitor: such conduct would violate Section 1 of the Sherman Act.⁶ Thus, any investigation of patent consortiums – where those consortiums are comprised of competitors – also must be analysed under Section 1 to determine whether the combination was formed in an effort to exclude a party that did not participate in a consortium.

As far back as the decision in *United States v. Singer Manufacturing Co.*, the US Supreme Court has held that it is unlawful for competitors to concertedly use patents to hinder or exclude a competitor from the market.⁷ In *Singer*, three parties – the leading makers of sewing machines – conspired concerning potential litigation with respect to the parties’ patents and patent applications in the United States.⁸ After entering into a series of cross licences, one of the firms raised the possibility that, “having arrived at their respective agreements, [they] should act in concert in prosecuting their patents against all others in the field.”⁹ Thereafter, the parties engaged in such a course of conduct that achieved precisely the end suggested by one of the group’s members – the exclusion of “their common competitors, the Japanese manufacturers.”¹⁰

One of the defendants argued that the licence served the purpose of allowing the manufacturers to practice their inventions free of infringement claims from the others. The Supreme Court found that unavailing: “[the] fact that the enforcement plan likewise served Singer is of no consequence, the controlling factor being the overall common design, i.e., to destroy the Japanese sale of infringing machines in the United States by placing the patent in Singer’s hands the better to achieve this result. . . . [I]t [wa]s this concerted action to restrain trade, clearly established by the course of dealings, that condemn[ed] the transactions under the Sherman Act.”¹¹

CPTN, Rockstar and Google’s Acquisition of Motorola Mobility. CPTN is a holding company equally owned by Microsoft Inc., Oracle Corp., Apple Inc., and EMC Corp., that agreed in November 2010 to acquire patents from Novell in connection with Novell’s merger with Attachmate Corporation. The agreement raised antitrust concern, in part, because each of CPTN’s owners had a history of attacking open-source software projects through patent litigation, and some of Nortel’s patents are related to Unix, which the companies could use to attack mobile platforms based on Linux. In light of these

concerns, the Open Source Initiative (OSI) and Free Software Foundation (FSF) spoke out against the transaction, noting that the sole or leading competition to the owners of CPTN for some products are open-source alternatives.¹² Because open-source software has been such an important force in encouraging competition in the technology industry, the DOJ opened an investigation to look into the competitive effects of the patent acquisition. After the initiation of an investigation by the DOJ, CPTN agreed to make several changes to the agreement with Novell to address competition, providing that:

- Microsoft would sell back to Attachmate all of the Novell patents that Microsoft would otherwise have acquired, and receive a licence for the use of those patents acquired by the other three CPTN owners and any patents retained by Novell;
- EMC would not acquire 33 Novell patents related to virtualisation software;
- All of the Novell patents would be acquired subject to the GNU General Public License and a licence to the Open Invention Network (OIN), a significant conglomeration of patents designed to allow OIN members to defend the Linux ecosystem,
- Neither CPTN nor its owners could make any statement or take any action to influence or encourage either Novell or Attachmate to modify which of the patents are available under the OIN licence.¹³

Although recognising that the changes to agreement were helpful, to this day, the DOJ continues to investigate whether the distribution of the patents could impair competition, particularly by stifling open-source competition.

More recently, Rockstar, a consortium of the most significant mobile phone open-source and hardware market participants, including Apple, Microsoft and Research in Motion (RIM), joined to bid 4.5 billion dollars in an auction of Nortel’s patents after the company declared bankruptcy. The group outbid Google, which entered a starting bid of 900 million dollars for the portfolio, which had an estimated value (pre-auction) of one billion dollars.¹⁴ The American Antitrust Institute (AAI) spoke out regarding the competitive effects of the sale, sending a letter to the DOJ asking antitrust officials to investigate. The AAI stated:

The consortium membership includes three leading mobile device operating system competitors – Apple, Microsoft and Research in Motion. They are the three main commercial rivals to Android, Google’s open-source mobile operating system... Each of them, moreover, appears to possess the ability and incentive to use its patents offensively against open-source as well as commercial competitors; their concerted control over the entire Nortel portfolio would seem to create a much-enhanced

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*collective ability and incentive to act in that manner, with a decisively exclusionary impact on open-source competition in particular. Why, in this light, should ANY horizontal collaboration among them (joined by three others with strong portfolios of their own as well) be allowed with regard to the Nortel portfolio, particularly in the absence of any transparent safeguards against anticompetitive effects from it?*¹⁵

The AAI went on to note that many of the patents in Nortel's portfolio have been adopted in industry standards, and that the consortium could demand excessive royalties for the technologies.¹⁶ Furthermore, on its official blog, Google called the group's actions "anticompetitive," arguing that the group acquired the patents (1) to make sure Google did not get them to allow it to defend itself against patent suits, (2) to seek significant licensing fees for Android devices, (3) to make it more expensive for phone manufacturers to license Android (which is currently free) than Windows 7, and (4) to sue mobile-device manufacturers for patent infringement.¹⁷ Microsoft responded to Google's allegations on Twitter, claiming that the consortiums are meant to reduce patent liability across the industry. The DOJ is currently investigating whether the Rockstar group members acquired the patents for anticompetitive means.

Meanwhile, on 15 August this year, Google announced that it would acquire Motorola Mobility for 12.5 billion dollars, to obtain patents that could be used to defend against lawsuits targeting handsets and tablet computers that use Google's

Android operating system. Google justified the acquisition as a means to gain access to more than 17,000 Motorola patents. The acquisition has highlighted the costs that the current system inflicts on competition and consumers. As one commentator put it: "This is 12.5 billion dollars that one of America's most creative companies will not use to innovate, fund research or hire anyone beside patent lawyers."¹⁸ In light of this cost, patent reform has become an increasing priority. Earlier this year, both the House and the Senate passed patent reform bills. The House version is scheduled to be taken up by the Senate in September.

The acquisition and assertion of IP rights represents a significant present and future battlefield in technology markets. Because the patent system in the United States presently is unable to manage the number of filings nor make substantive determinations of the validity of patents prior to their issuance, the cost of the assertion of those IP rights will continue to rise. If something is not done about the patent system as it presently operates, the antitrust authorities will need to continue to interject themselves, in order to police whether firms are improperly asserting such rights to anticompetitive ends. ■

Scott Sher is a partner at Wilson Sonsini Goodrich & Rosati's Washington office. Kara Kuritz is an associate. The views expressed in this article are personal to the authors and do not reflect the view of WSGR or any of its clients.

Footnotes

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- 2 *Google's Motorola Deal Shows Need for Better Patent System*, Bloomberg (Aug. 18, 2011), available at <http://www.bloomberg.com/news/2011-08-19/google-s-motorola-deal-shows-need-to-develop-better-patent-system-view.html>.
- 3 Federal Trade Commission, *The Evolving IP Marketplace, Aligning Patent Notice and Remedies with Competition* (Mar. 2011), available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf>.
- 4 U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property*, § 2.1 (Apr. 6, 1995) available at <http://www.justice.gov/atr/public/guidelines/0558.htm>.
- 5 *Id.*
- 6 15 U.S.C. § 1.
- 7 374 U.S. 174, 83 S.Ct. 1773.
- 8 *Id.* at 175.
- 9 *Id.* at 181.
- 10 *Id.* at 189.
- 11 *Id.* at 195.
- 12 See Brett Smith, *OSI and FSF Send Joint Position to the Department of Justice* (Jan. 20, 2011), available at <http://www.fsf.org/news/osi-fsf-joint-position-cptn>.
- 13 Press Release, U.S. Department of Justice, *CPTN Holdings LLC and Novell Inc. Change Deal in Order to Address Department of Justice's Open Source Concerns* (Apr. 20, 2011), available at <http://www.justice.gov/opa/pr/2011/April/11-at-491.html>.
- 14 David Drummond, *When Patents Attack Android*, The Official Google Blog (Aug. 3, 2011), available at <http://googleblog.blogspot.com/2011/08/when-patents-attack-android.html>.
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- 16 *Id.*
- 17 *Id.*
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