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Patent Remedies: Can *Quanta* Finish What *eBay* Started?  
(Oral remarks delivered to the Federal Trade Commission)  
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I would like to first thank the Commission for holding today's hearing. A remedies discussion is particularly timely and topical because we're seeing clear signs of a market failure - a market failure in the marketplace for ideas.

If we listen closely to the marketplace for ideas, it is echoing a similar message that the financial markets are sending: That is, an overstressed and outdated rule set is causing a lack of transparency, in turn leading to the mispricing of assets.

The stressed and outdated rule set here, and that is the subject of my discussion specifically, is the entire market value rule construct for patent infringement damages.

And the asset mispricing occurring, of course, are patent assets which are unable to be priced based on fundamentals.

The last time we saw the very symptom of this phenomenon was with the automatic injunction rule at issue in the *eBay* case. As a result, the four major financial service industry associations comprising many thousands of member companies, filed a first-ever patent law amicus to the Supreme Court in order to shed light on the contours and specific market effects of the problem. We argued successfully that courts should have discretion in appropriate circumstances to balance competing harms and interests. One such circumstance is where an

injunction would disrupt or dislocate the U.S. financial system and markets. Another is where the enforcer is a non-practicing entity, which provides no goods or services.

The practical result from the *eBay* decision tells us that the market works, that patents can and should have more value in the hands of commercial competitors versus non-practicing entities ("NPE's"). Monetary damages may, in fact, make a NPE whole, whereas commercial competitors may suffer irreparable harm.

If we carry this concept forward, we have to ask, what then is the appropriate measure of monetary damages for patent infringement? If we look to current damages jurisprudence, we see a market failure resulting in rules fashioned in a bygone era in a marketplace with relatively few patents. As a result, the current landscape is skewed towards predatory litigation and has created a lottery ticket mentality that all but drowns out any legitimate marketplace price signal on patent valuation.

This is because patent owners are able to obtain damages awards on components that they did not invent and are not covered by the claims of the patent. This results in a market distortion, which is particularly profound in industries with complex value chains where end products or services can literally be the subject of hundreds, if not thousands, of patents.

While incentives to obtain patents are strongly reflected in their growing number, the remedial regime to compensate patent owners for infringement has not kept pace. This lag has led to the rise of predatory litigation and litigation abuses that are straining the system and calling into question the very role of patents in the modern economy. Indeed, as I testified to the

Senate Judiciary Committee, Professor Josh Lerner's work confirms that the financial services industry alone is 27 times more susceptible to patent litigation.

As a result, available patent remedies need to be sharpened so that a patent owner's remedy is valued in accordance with the specific contribution of the invention, while preserving full valuation under current remedies for more traditional, patent reliant and mature industries.

A fundamental tenet of economics is that a free market most efficiently values goods and services. Indeed, patent law embraces this principle:

[I]t is one of the legal beauties of the system that what is given by the people through their government - the patent right - is valued automatically by what is given by the patentee. His patent has value directly related to the value of his invention, as determined by the marketplace.<sup>1</sup>

Recent decisions, however, demonstrate that patent damage awards can grossly exceed market rates. This phenomenon is perhaps best evidenced by the *Eolas Technologies, Inc. v. Microsoft Corp.*<sup>2</sup> case.

In the Microsoft case, the jury awarded Eolas a royalty of \$520,562,280 because the Court allowed the royalty calculation to be based on the value of the entire Windows® operating

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<sup>1</sup> See *Application of Kirk*, 376 F.2d 936, 964 (CCPA 1967) (Rich, J. dissenting).

<sup>2</sup> 273 F. Supp. 2d 972 (N.D. Ill. 2003), *rev'd on other grounds*, 399 F. 3d 1325 (Fed. Circ. 2005).

system, even though the infringing component represented only one small part. The plaintiff was allowed to leverage its specific contribution -- an interactive browser -- to obtain a royal case for a far more complex system that it admittedly did not invent -- the Windows® operating system.

This is not a market-based calculation, but rather a symbol of how the law on patent damages has moved away from market principles, particularly for goods and services that have complex value chains.

Calculating a reasonable royalty consists of a two step process; (1) establishing a royalty base; i.e. the total value of the infringer's sales on which the patent owner is entitled to royalty payments; and (2) establishing a reasonable royalty rate to apply to the base. This approach is consistent with an overall philosophy of relying on market forces in calculating compensation to the patent owner. This policy is thwarted, however, if the royalty base is artificially high or low.

Now, modern technology often involves interrelated components that are sold to the consumer as part of a functional unit. Many of these components are the subject of patent protection and can be combined in multiple ways to yield new and improved systems or methods. If, however, each individual patent owner has a possibility of obtaining a damage award on the price of the entire end product, an incentive arises to engage in patent litigation over licensing.

I will use an example to help illustrate: Suppose a particular product sold by E is the subject of 4 patented components A thru D. The product itself sells for \$10.00 and each individual component sells for \$2.00. If the owners of A, B, C, and D enter into a license

arrangement with E, each receiving a 10% royalty on the price of their component or 0.20¢, E is still left with a 12% profit. Now suppose that one of the patent owners, D, decides to bring patent litigation and is successful in arguing that the end product is sold as a functional unit including his patented component. Now further suppose he is successful in obtaining a royalty rate of 5% -- half of the component rate of 10% -- on the total price of \$10.00. As a consequence, D is receiving 0.50¢ per unit.

A number of serious problems are illustrated by this example.

First, D is rewarded by choosing to litigate rather than license. This distortion results in a jackpot litigation mentality that diverts economic activity to less productive purposes. Perhaps even more important is the impact of E. Recall that under a licensing regime where each patent owner is paid a royalty based on their specific contribution, E is still left with a 12% return on the sales price. If D is successful in obtaining a royalty based on the entire market value, then E's return drops to 9%. Stated simply, this 25% reduction in E's return will have a real impact on E's willingness to sell the product and will no doubt stifle innovation.

Now, I should note that my example is an extremely simplified example. Most modern products involve scores, if not hundreds of patents. This fact only magnifies the problem.

Second, the uncertainty of the end result chills innovation and prevents proper market-pricing of the patent.

Finally, the appearance of a new actor on the stage -- the non-practicing entity -- has altered the dynamic. NPEs do not actually practice their patents.

Two important implications arise out of this development. First, the NPE, unlike the actual manufacturer, has no fixed costs in creating the patented component. Commercial suppliers, having fixed costs, mitigate some of the risk of pursuing a litigation strategy that may ultimately chill production. Think back to our example involving E. If anyone of A, B, C or D brings litigation seeking a royalty based on the entire market value of the end product, they run the risk of having E redeploy his capital to a more profitable alternative. Stated simply, if A, B, C or D actually manufacture the components -- as contrasted with a non-practicing entity -- they are less likely to engage in activity that will undermine the production of articles that include his or her components.

Second, the preferred NPE model is to maximize short-term gain. This leads to a jackpot mentality that further tips the playing field in favor of predatory litigation where NPEs can do better than those actually making the products.

A more consistent and uniform approach would be to limit the application of the entire market value to situations where the patented component is the entire basis for consumer demand. This formulation has several critical advantages. First, it would insure that leveraging a patent beyond its scope is the exception rather than the rule. Second, the application of this formulation should reduce uncertainty and, therefore, the distortions that occur when the system can be gamed as seen by example. Finally, this approach is consistent with the Supreme Court's jurisprudence on patent law.

The Supreme Court recently provided further insight on this theme in *Quanta*<sup>3</sup> and this may be of particular interest to the Commission. While *Quanta* involved the doctrine of patent exhaustion, part of the rationale behind the doctrine is to prevent patent owners from leveraging their patents to secure market control of related but unpatented items. In *Quanta*, the Court was forced to consider the extent to which a product must embody a patent to trigger the exhaustion doctrine.<sup>4</sup> As an initial matter, the Court traced its own jurisprudence lamenting the "increasing frequency" in which patent owners were using license terms to secure market control of related, unpatented items.<sup>5</sup> The Court further noted that the primary purpose of the patent laws is not the creation of private fortunes but the promotion of the progress of science and the useful arts.<sup>6</sup> Consequently, the Court observed that patents rights are *limited to the invention described in the claims* and courts should focus on the inventive aspect of the claims as distinguished from standard components.

The teachings of *Quanta* are instructive to the application of the entire market value rule. Indeed, the logic and rationale of not allowing a patent owner to secure control over non-

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<sup>3</sup> *Quanta Computers, Inc. v. LG Electronics, Inc.*, 128 S. Ct. 2109 (2008).

<sup>4</sup> *Id.* at 2115.

<sup>5</sup> *Id.* at 2116.

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

patented but related items as part of a licensing strategy stands in contrast to the current entire market value rule that allows a patent owner to capture a royalty for damages for non-patented but related items used in combination with patented items. As in *Quanta*, the royalty calculation should rightfully be focused on the inventive aspect of the claims and should not be extended to standard, non-inventive components absent exceptional circumstances. This premise is only underscored by the Court's admonition that the patent laws are not designed to create private fortune but to promote innovation.

Any proposed damages regime should insure that a patent owner's royalty is limited -- except in exceptional and provable circumstances -- to the economic value of the infringing product or process attributable to the claimed invention's specific contribution. This process can and should take into account market forces.

So, to conclude, and to answer the question posed in my presentation "Can *Quanta* finish what *eBay* started"? I would echo the refrain that recently was so successful this election season - "Yes we can."