

# State Notes

## TOPICS OF LEGISLATIVE INTEREST

Fall 2014



### A Summary of Patent Troll Activity and State Law By Jeffrey Mann, Legislative Analyst

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#### Introduction

Patents are generally perceived to be a net social good, exchanging a limited-time right to exclude others from making an invention for the public disclosure of that knowledge. Recently, however, the proliferation of many computer and business method patents and associated litigation conducted by entities that do not practice these patents have led some to recommend legislative changes meant to ensure that assertions of patent infringement are made in good faith.<sup>1</sup> In Michigan, a bill that was recently introduced in the House of Representatives is purported to do exactly that. This article begins by introducing the basic concepts of patents and the Federal law of patents. A brief overview of nonpracticing entities follows. The article then discusses issues and arguments pertaining to the perceived merits and shortcomings of patent assertion entities. Finally, the article introduces the concept of state regulation as an approach to restricting bad-faith demand letters<sup>2</sup>, and briefly discusses the bill introduced in the Michigan House of Representatives.

#### Basics of Patents and Patent Laws

A patent is a right granted by a government to an inventor to exclude others from making, using, or selling an invention for a defined period of time.<sup>3</sup> Patents function as a *quid pro quo* of sorts in that the rights granted by a patent are a limited-time monopoly in exchange for a disclosure of the invention to the public. This, in theory, creates an incentive for inventors and entrepreneurs to allocate money and resources to developing new technology in the hopes that they will be able to patent the invention and derive the benefits from the patent, while disclosing to society the way the invention works. In the United States, the patent system is specifically provided for in the U.S. Constitution, and is regulated under Federal law.<sup>4</sup> Patents are granted by the United States Patent and Trademark Office (USPTO), which resides within the Department of Commerce.

To qualify for a patent, an invention must meet four basic requirements. First, the invention must be patentable subject matter. Patentable subject matter includes any process, machine, manufacture, or composition of matter; laws of nature, abstract ideas, or natural phenomena are not patentable.<sup>5</sup> Second, an invention must be useful.<sup>6</sup> The third requirement is that the invention be novel. An invention is not considered novel if the invention "was patented, described in a printed publication, or in public use, on sale, or otherwise available to the public before the effective filing date of the

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<sup>1</sup> An entity that "practices" its patents uses them to design or manufacture products or processes.

<sup>2</sup> As discussed below, such letters demand that an alleged patent infringer buy a license in order to avoid being sued.

<sup>3</sup> It is a common misconception that a patent grants a patentee the right to practice the invention. A patent cannot grant such a right because one patent might be dependent on another patent to practice a particular technology. A patent granted from an application filed after June 8, 1995, is valid for 20 years from the filing date of the application. Before June 8, 1995, a patent was valid for 17 years from its issue date. The term can be adjusted because of examining delays or, for pharmaceutical patents, delays associated with gaining U.S. Food and Drug Administration approval.

<sup>4</sup> Specifically, Congress has the power to "promote the progress of science and useful arts, by securing for limited times to...inventors the exclusive right to their...discoveries", U.S. Constitution Art. I, § 8, cl.8.

<sup>5</sup> 35 U.S.C. § 101.

<sup>6</sup> *Id.* As a general matter, patents are seldom challenged on utility grounds.



claimed invention", unless certain conditions are met.<sup>7</sup> Finally, the invention must be nonobvious. An invention is nonobvious when, at the time the invention was made, it would not have been obvious to a person having ordinary skill in the art pertaining to the invention.<sup>8</sup>

To obtain a patent, one must file a patent application with the USPTO. The first inventor to file an application is awarded the patent.<sup>9</sup> The application must disclose the best mode for practicing the invention, and must meet the "enablement" requirement; that is, the application must disclose the invention in a manner that allows a person skilled in the art to make and use the invention without undue experimentation.<sup>10</sup> The application is reviewed by an examiner who analyzes the patent for compliance with all the applicable patent laws and regulations and either grants, or more typically, rejects the patent application. The application may go through multiple rounds of amendment and rejection before the application is granted, and a patent is issued, or the application is abandoned. A patent is composed of two general parts: 1) a specification, which describes a technical background of the problem the patent attempts to solve, a description of the invention, a drawing of the invention, and other information pertaining to the claimed invention, and 2) a set of claims, which articulate exactly what is covered under the patent.

Patents are considered personal property and are treated accordingly. While only an inventor can file for a patent, any legal person can own patents.<sup>11</sup> Patents can be licensed, assigned, abandoned, donated to the public, or used as security.<sup>12</sup> Patent rights are enforced primarily through an infringement suit, or the threat of such a suit. A person who, without authority, imports, makes, uses, or sells a product covered by a patent is liable as an infringer.<sup>13</sup> This is considered direct infringement. A person also can indirectly infringe by actively inducing another to infringe,<sup>14</sup> or by selling, offering to sell, or importing a component of a material part of a patented invention knowing the component was made or adapted for use in an infringement.<sup>15</sup> Damages against an infringer can

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<sup>7</sup> 35 U.S.C. § 102. The conditions have to do with certain activities of the inventor that are beyond the scope of this paper.

<sup>8</sup> 35 U.S.C. § 103. This is often called the PHOSITA (person having ordinary skill in the art) test. The PHOSITA is a "legal fiction", much like the reasonably prudent person in United States tort law.

<sup>9</sup> Until the America Invents Act was passed, the United States was one of a few countries that had a "first to invent" requirement.

<sup>10</sup> The best mode requirement requires the inventor, in the specification of the patent, to set forth the best way to practice the invention. 35 U.S.C. § 112(a). Enablement also is required under § 112(a); the undue experimentation test was set forth by the U.S. Supreme Court in *Mineral Separation v. Hyde*, 242 U.S. 261, 270 (1916).

<sup>11</sup> An inventor must be a natural person. Many of the patents that are applied for are done so on behalf of large companies involved in high-technology research and development. It is a customary condition of employment at these companies that any patent granted to an employee of the company for an invention developed in the course of his or her employment or that used company resources must be assigned to the company.

<sup>12</sup> The licensing of patents takes two forms: exclusive and nonexclusive. An exclusive license grants all rights under the patent to the licensee, and the patent owner retains title to the patent. An exclusive license can be limited to field or geography. This means that multiple exclusive licenses can be granted. If the field or the geographical scope of the license is limited, the licensee can exercise all of the rights within the scope of field or geography. A nonexclusive license is basically a forbearance from an infringement lawsuit granted to a licensee.

<sup>13</sup> 35 U.S.C. § 271(a).

<sup>14</sup> 35 U.S.C. § 271(b).

<sup>15</sup> 35 U.S.C. § 271(c).



be extensive. At a minimum, the infringer is subject to damages that equal a reasonable royalty, but also may include lost profits, and for certain cases, treble damages, attorney fees, and costs.<sup>16</sup>

### **Nonpracticing Entities and Patent Assertion Entities**

A nonpracticing entity (NPE) holds a patent for a process or product but does not exercise the underlying art. There are many reasons why an entity may choose not to practice a patented technology. For example, most universities are considered NPEs. A university's faculty members, particularly those in high-technology sectors such as biotechnology or engineering disciplines, might develop patentable technologies in the course of their research. The university might have the resources to secure a patent, but not to bring the product to market. University technology transfer offices will license the patents, usually exclusively, to companies that are capable of developing the technology.<sup>17</sup> Large companies also qualify as NPEs to the extent that they purchase patents through subsidiaries to assert against their competition or to use them defensively.<sup>18</sup>

Another group of NPEs are the so-called "patent assertion entities" (PAEs). These companies operate by purchasing patents and holding them in a portfolio. The patents might come from a variety of sources, such as a failed business looking to liquidate its patent portfolio or a small-scale inventor who cannot afford to develop the technology on his or her own. A PAE will not practice the art and generally will not grant a license preemptively. Instead, the PAE will monitor the market for products or processes that could infringe on a patent in its portfolio. In some cases, PAEs have been accused of waiting until a company makes a significant investment or takes other irreversible action on technology that the PAEs believe is covered by the patent.<sup>19</sup> When infringement activity is suspected, the entity will issue a demand letter requesting that the suspected infringer take a nonexclusive license to avoid being sued. Occasionally, these letters are sent indiscriminately and there have been reported instances in which a form demand letter was sent to multiple parties.<sup>20</sup> Sometimes, a demand letter expresses nothing more than a vague statement or assertion that the party to whom the letter is addressed might be infringing an unnamed patent, or patents. Because of these tactics, PAE detractors have used colorful pejorative nicknames such as "patent sharks", "patent pirates", and more commonly, "patent trolls".<sup>21</sup>

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<sup>16</sup> 35 U.S.C. §§ 283-285. Treble damages are typically awarded in instances of willful infringement.

<sup>17</sup> See Mark A. Lemley, "Are Universities Patent Trolls?", 18 *Fordham Intellectual Property, Media and Entertainment Law Journal* 611 (2008) for an in-depth discussion of university patent licensing and technology transfer activities and the resulting issues.

<sup>18</sup> A patent litigation strategy employed by large industrial entities has been to purchase a large number of patents related to the technology they research, manufacture, and sell. These patents may be used to develop new technology or conduct research, but they can also be asserted in a counterclaim against a party who has claimed infringement. This kind of "mutually assured destruction" can sometimes keep litigation from going too far.

<sup>19</sup> See "Patent Assertion and U.S. Innovation", Executive Office of the President, p. 4 (2013).

<sup>20</sup> In one case, a PAE sent nearly 8,000 demand letters to various suspected infringers. See Ashby Jones, "Cisco's Patent Counterattack Fails", *Wall Street Journal*, 2-6-2013, retrieved 10-13-2014 at: <http://online.wsj.com/news/articles/SB10001424127887324906004578288370005621206>.

<sup>21</sup> The term "patent troll" was coined by the Intel legal team from the mythical beast who hides under a bridge it did not build to demand a toll from people crossing the bridge.



## The Growth of Trolls

Some believe that the business tactics described above are the consequence of a combination of issues endemic within the patent legal landscape and the technological backdrop of the last 20 years. Several studies have demonstrated a marked increase in PAE litigation activity. In 2010, PAEs brought approximately 731 lawsuits, or 29% of all patent lawsuits.<sup>22</sup> In 2012, the number was 2,500 lawsuits, nearly 62% of all patents lawsuits. There are a few likely reasons for this increase.

The first factor has to do with the patent litigation landscape and how PAEs fit into it. In most nations, the rule for assigning costs for conducting litigation is the so-called "loser pays" system in which the party that loses the case pays its costs and the winner's litigation costs.<sup>23</sup> In the United States, this is generally not the case; each party pays its own costs. Filing a lawsuit in the United States is also relatively inexpensive. For these reasons, the barrier to entering into a patent lawsuit can be fairly low.

On the other hand, patent litigation between traditional parties can entail a high amount of risk. First, litigating a patent can be quite expensive.<sup>24</sup> These trials require specific experts, specially trained attorneys, and extensive discovery. The process can be significantly more expensive if a large company decides to employ a protracted, "scorched earth" litigation strategy as a tactic (usually against a smaller or less well funded competitor).<sup>25</sup> Second, an accused infringer will usually stop researching and marketing an infringing product. This costs time and money; however, if it continues to infringe, the infringer could be subject to treble damages, in addition to lost profits, attorney fees, costs, and the prospect of having to negotiate a license with a party whose patent was willfully infringed. Moreover, the traditional plaintiff also must tread lightly, as the defendant could counterclaim for infringement of its own patents, the plaintiff could be seen as a bully from a public relations perspective, or a court could easily invalidate the infringed patent, ending a stream of licensing royalties. These factors have encouraged a scheme of settlement, negotiation, licensing, and cross-licensing.<sup>26</sup>

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<sup>22</sup> Colleen Chien, "Patent Assertion Entities" Presentation at Joint Federal Trade Commission and Department of Justice Workshop on PAEs, 12-10-2012:  
<http://www.justice.gov/atr/public/workshops/pae/>. It is not clear if the numbers cited in this presentation take into account changes to joinder of parties set forth by the America Invents Act, which would have likely increased the total number of cases filed, but not the total amount of actual activity. For a discussion of these changes, see Maya M. Eckstein, et al., "The (Unintended) Consequences of the AIA Joinder Provision", Paper, AIPLA Spring Meeting, 5-2012:  
<http://www.hunton.com/professionals/uniEntity.aspx?xpST=ProfessionalDetail&professional=145&op=publications&ajax=no>.

<sup>23</sup> Marie Gryphon, "Greater Justice, Lower Cost: How a 'Loser Pays' Rule Would Improve the American Legal System", *Civil Justice Report* No. 11-Manhattan Institute for Policy Research (2008):  
[http://www.manhattan-institute.org/html/cjr\\_11.htm](http://www.manhattan-institute.org/html/cjr_11.htm).

<sup>24</sup> The American Intellectual Property Law Association (AIPLA) conducted a survey of its members in 2011. The survey indicated that the median cost of litigating a patent can range from \$650,000 (where less than \$1 million is at risk) to \$5 million (more than \$25 million at risk). See American Intellectual Property Law Association, "Re: Comments on the FTC/DOJ Patent Assertion Entity Activities Workshop, December 10, 2012." 4-5-2013  
<http://www.justice.gov/atr/public/workshops/pae/comments/paew-0046.pdf>.

<sup>25</sup> M. Craig Tyler, "Patent Pirates Search for Texas Treasure", *Texas Lawyer*, 9-20-2004.

<sup>26</sup> See n. 17, at 5.



By virtue of their business model, PAEs eliminate most of these risks, while taking advantage of the low barrier to file lawsuits. First, demand letters, especially those with vague assertions of patent infringement, are inexpensive and can be widely disseminated, scaring some businesses into taking a license immediately. Many PAEs have attorneys who charge on a contingency basis, which keeps the PAEs' initial costs of filing lawsuits and other preliminary work low.<sup>27</sup> The documents needed for discovery and trial are typically produced ahead of time. As a rule, PAEs have few employees and few assets (with the exception of their patent portfolio).<sup>28</sup> A PAE generally does not need to worry about public perceptions because it does not market products to the public. Meanwhile, because a PAE does not have product lines, does not conduct research and development, and will not lose money from not putting out a potentially infringing product, the time and cost of defending a patent lawsuit work to the PAE's advantage. For these reasons, PAEs also are less vulnerable to "scorched earth" litigation employed by large companies.

Another set of issues pertains to the type of technology involved in the patents being asserted by PAEs. A wide range of technology is subject to the patent preparation and prosecution process.<sup>29</sup> Some fields, such as biotechnology and pharmaceuticals, rely heavily on the 20-year term of patents to recoup the significant investments needed to bring products to market. It has been argued that other inventions, typically those involving communications, software, and computers, are rendered obsolete more quickly, have wider claim breadth, and are accordingly subject to greater abuse.<sup>30</sup>

Supporters of PAEs argue that these entities generate a secondary market for patents, particularly for individuals or businesses that might need to sell patents quickly for any number of reasons, or that prosecute a patent but do not wish to maintain it in their portfolio.<sup>31</sup> There is some evidence suggesting that this secondary market is helpful and drives innovation to some degree by providing small-scale inventors and start-ups with needed capital.<sup>32</sup> In addition, some claim that PAEs reduce transaction costs and give small-scale inventors a chance to enforce their patent rights at the expense of large companies that might engage in protracted litigation.<sup>33</sup>

On the other hand, detractors contend that PAE activities run contrary to the intent of the patent system and are a net drag on the economy.<sup>34</sup> Reportedly, the vast majority of money extracted from settlements and lawsuits has not gone to individuals or start-ups, but rather to the companies conducting these activities.<sup>35</sup> In addition, some contend that PAEs assert improperly granted, and

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<sup>27</sup> Tyler, n. 23.

<sup>28</sup> *Id.*

<sup>29</sup> The term "prosecution" typically relates to plaintiff-side litigation; however, in patent parlance, prosecution relates to a patent attorney and inventor's interactions with patent examiners throughout the patent application process and subsequent interactions with the USPTO once the patent is granted.

<sup>30</sup> See n. 17, at 7-9; Thomas A. Hemphill, "The Paradox of Patent Assertion Entities", *The American Magazine*, 8-12-2013, retrieved 10-13-14 at: <http://www.american.com/archive/2013/august/the-paradox-of-patent-assertion-entities>, for a discussion on this point.

<sup>31</sup> See Hemphill, n. 28.

<sup>32</sup> See Chien, n. 20.

<sup>33</sup> See Hemphill, n. 28.

<sup>34</sup> See n.17, at 12; Hemphill, n. 28.

<sup>35</sup> James E. Bessen, et al., "The Private and Social Costs of Patent Trolls", Boston University School of Law, Law and Economics Research Paper No. 11-45, 9-19-2011.



often weak, patents.<sup>36</sup> In doing so, they derive income from asymmetrical "warfare". This, detractors claim, ultimately creates barriers to entry for entrepreneurs and small businesses, and hampers innovation.<sup>37</sup>

### **Regulation of NPEs and Infringement Suits**

While there is definite interest in curbing certain practices of PAEs at the Federal level, most efforts designed to achieve that end have stalled.<sup>38</sup> Since early 2013, states have attempted to alleviate the perceived problems of PAEs through the legal mechanisms available to them. Most of these efforts focus on a PAE's practice of issuing vague or misleading demand letters. In May 2013, Vermont enacted the first state law regulating patent trolls.<sup>39</sup> Since then, according to the National Conference of State Legislatures, at least 17 other states have passed similar measures, and other states, including Michigan, have proposed such legislation.<sup>40</sup>

Some of these efforts, including Michigan's House Bill 5701, attempt to differentiate between a "good faith demand letter" and a "bad faith demand letter". One of the preferred mechanisms for doing this in the legislation is to amend the state's unfair or deceptive trade practices law, while other laws or bills create or propose a new act governing the practice of issuing demand letters.<sup>41</sup>

House Bill 5701, sponsored by Representative Mike Callton and referred to the House Committee on Michigan Competitiveness, would enact the "Bad-Faith Patent Infringement Claims Act". The bill would prohibit a person from making a bad faith assertion of patent infringement, and would allow a court to consider certain factors as evidence of a bad faith assertion. Factors to be considered would include, for example, not providing certain information in a demand letter (for instance, the patent number or patentee or assignee information), demanding unreasonable royalty fees, or failing to conduct an analysis comparing the patent's claims to the target's products, services, or technology. The bill also would prescribe factors for determining what would constitute a good faith assertion of patent infringement. Like many of the other states' legislation, House Bill 5701 would allow the Attorney General to conduct civil investigations and bring civil actions. The bill also would allow the target of a bad faith assertion to bring a civil action. If successful, the target could receive equitable

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<sup>36</sup> This assertion is commonly made, with mixed support from scholars and attorneys. See, for example, Hunter Keeton & Edmund J. Walsh, "Death Knell for Patent Trolls", *Asia IP*, 5-2012: <http://www.wolfgreenfield.com/newsstand/522-death-knell-patent-trolls>; compare with Timo Fischer & Joachim Henkel, "Patent trolls on markets for technology – An empirical analysis of NPEs' patent acquisitions", 41 *Research Policy* 1519, 11-2012 (arguing that patents held by NPEs are of higher quality than those held by practicing entities).

<sup>37</sup> See n. 17 & 33.

<sup>38</sup> See, for example, Kate Tummarello, "Patent reform bill dealt fatal blow in Senate", *The Hill*, 5-21-2014, retrieved 10-15-2014, at: <http://thehill.com/policy/technology/206793-leahy-takes-patent-reform-off-committee-agenda>.

<sup>39</sup> Eric Goldman, "Vermont Enacts The Nation's First Anti-Patent Trolling Law", *Forbes*, 5-22-2013, retrieved 10-15-2014, at: <http://www.forbes.com/sites/ericgoldman/2013/05/22/vermont-enacts-the-nations-first-anti-patent-trolling-law/>.

<sup>40</sup> "Patent Trolling Legislation", National Conference of State Legislatures, 10-13-14: <http://www.ncsl.org/research/financial-services-and-commerce/patent-trolling-legislation.aspx>.

<sup>41</sup> Compare, for example, Louisiana's House Bill 564 (2014), at <http://www.legis.la.gov/legis/BillInfo.aspx?s=14RS&b=HB564&sbi=y>, with Michigan's H.B. 5701 (2014), available at the Michigan Legislature website: <http://www.legislature.mi.gov>.



remedies, damages, costs and attorney fees, and exemplary damages equal to \$50,000 or treble damages, whichever were greater.

State efforts to regulate PAE conduct will likely be reviewed by the courts in the near future. The main issue that will confront such legislation is whether it would be preempted by the Federal law governing patents. The United States Constitution establishes the Constitution, Federal statutes, and treaties as the "supreme law of the land".<sup>42</sup> From this, the courts have fashioned the doctrine of Federal preemption. There are three types of Federal preemption: express preemption, conflict preemption, and field preemption. Express preemption occurs when a Federal statute explicitly indicates Congress's intent that the statute supersede state laws.<sup>43</sup> Under conflict preemption, state law is preempted if it conflicts with Federal law. A conflict occurs if the state law is an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.<sup>44</sup> A conflict also occurs if a party is unable to comply with Federal and state law.<sup>45</sup> In the absence of a conflict or an express intent to supersede state law, a court may still infer intent to preempt state law if the Federal regulatory scheme is so pervasive as to "occupy the field" in that area of the law.<sup>46</sup> For some of the measures being advanced, a conflict could arise if a factor considered evidence of a bad faith demand letter is an activity permitted by the law of patents.

## **Conclusion**

Notwithstanding concerns of Federal preemption, a state law prohibiting an entity from making a bad faith assertion of patent infringement with well-defined "bad faith" factors could be an effective way to prevent abusive patent litigation while ensuring that those whose patents are actually being infringed have an avenue to address their concerns with the infringer. It also could ensure that those who are innovating, producing, and marketing in good faith have sufficient information to continue their operations and could enable them to make well-informed licensing decisions if the need arises. A cautious approach with regard to PAEs may separate those entities who are interested in acting as a beneficial intermediary for small-scale investors in their assertion of patents from those who are not.

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<sup>42</sup> Specifically, Article VI, cl. 2 states, "This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, any thing in the Constitution or laws of any state to the contrary notwithstanding."

<sup>43</sup> *English v. General Electric*, 496 U.S. 72, 78-79 (1990).

<sup>44</sup> *Gade v. National Solid Wastes Management Association*, 505 U.S. 88, 115 (1992).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 98.