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U.S. Federal Trade Commission Recommends Changes to U.S. Patent System

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The U.S. Federal Trade Commission ("FTC") has issued a report analyzing the U.S. patent system from a competition policy perspective. The FTC recognizes that, like the competitive process fostered by competition law, the right to exclude provided by the intellectual property laws is intended to promote innovation and thereby benefit consumers. The FTC believes, however, that several aspects of the U.S. patent system could be improved to better achieve these goals. In particular, the FTC focuses on several situations where the patent system may provide certain patentees – especially what the FTC refers to as "patent assertion entities" (i.e., "patent trolls") – legal remedies that are far out of proportion to the importance of their inventions. The FTC believes that this "patent hold-up" problem overcompensates these patentees, which in turn distorts the competitive process and reduces overall innovation.

Ideally, a market participant developing a product can determine which patents might cover its product, and then decide whether to seek a license or design around each patent. If the party seeks a license at this stage (called "ex-ante licensing"), the negotiation should result in a royalty rate that fairly reflects the value of the patent as compared to the available alternatives. A central insight of the FTC Report, however, is that there are a variety of circumstances where market participants will not be able to identify in a timely and reliable manner which patents their products may infringe. If such a party invests significant sunk costs in its product, and a patentee subsequently contends that the product infringes, then the patentee may be able to take advantage of these high sunk costs when threatening a patent lawsuit and injunction. These "ex-post licensing" negotiations can therefore result in what the FTC calls "patent hold-up," where a patentee can coerce a potential infringer into a significant licensing payment even though the patented invention (i) may not have been copied by the alleged infringer when designing its product, and (ii) may not cover important technology (i.e., could easily have been designed around).

The potential inefficiencies generated by this situation are significant and will have a negative impact on innovation. To begin with, market participants must make product development decisions without full information as to the potential costs associated with different technology choices. Additionally, the extra costs incurred by a manufacturer in an "ex-post" licensing transaction will ultimately be passed on to consumers. This means that consumers must pay more for a product than they would have paid if the manufacturer in question had notice of the patent claims and could have made more efficient design choices. These higher prices will result in less demand and thus less reward for the innovative manufacturer.

The FTC Report makes recommendations to address these concerns in two principal areas: notice and remedies. With respect to notice, the FTC recommends several changes in an effort to improve the ability of market participants to identify and assess the scope of relevant patents. The FTC's recommendations would impose stricter rules against claims that are indefinite or overly broad, and include suggestions for procedures (such as improving the patent examination record at the U.S. PTO) that the FTC believes would provide outside parties with additional (and earlier) guidance in interpreting existing patent claims.

The second — and potentially more far-reaching — set of FTC recommendations relates to remedies. The FTC makes several suggestions in an effort to make sure that the damages awarded to a patentee are proportional to the value of the invention (i.e., that they replicate what would have been awarded in a competitive marketplace). Just as damages that are too low will encourage infringement and inhibit innovation, damages that are too high will impose costs on competition that are unnecessary to protect the patent system's incentives to innovate. One key element of the FTC Report is that infringement damages should reflect the value that the patent provides as compared to non-infringing alternative products. Thus, for example, if one were to calculate a reasonable royalty based on a hypothetical ex-ante licensing negotiation, the licensor would only be willing to pay an amount that reflected the value of the invention as compared to non-infringing alternatives. The FTC recommends that courts set this "hypothetical" negotiation at an early stage of product development, before the infringer has sunk costs into using the technology. The FTC also recommends that U.S. courts have greater authority to limit the admissibility of unreliable expert testimony on damages.

The FTC also made several recommendations about when a patentee should not be entitled to an injunction. The agency agreed with the standards set forth in the US Supreme Court decision in *eBay Inc v. MercExchange, L.L.C.*, 547 U.S. 388 (2006), which will have the effect of reducing the ability of "patent assertion entities" to obtain injunctions in certain circumstances. The ability of such entities to obtain an injunction can, in some situations, lead to a serious patent hold-up problem. Although it believes that injunctions should ordinarily be awarded, the FTC suggests a few factors that might weigh against equitable relief. These include (i) where the alleged infringer did not actually copy the invention subject to the patent, and (ii) where the patented invention is a minor element of the product subject to the injunction, and has numerous alternatives that the infringer could have chosen instead had it been aware of the patent claim.

The FTC's recommendations are tailor-made for certain more obvious "patent hold up" situations, such as where an industry standard is set by a standard setting body without notice of a relevant patent, or where a "patent assertion entity" takes advantage of sunk costs incurred by a manufacturer to coerce it into paying exorbitant fees to license unimportant patents that the manufacturer did not rely upon or copy when developing its products (and which it could have designed around had it been aware of the risk). Whether these recommendations can be implemented into a patent system that must balance numerous other considerations, including a majority of cases that do not involve the "patent hold up" problem, remains to be seen.

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