September 30, 2016

Patent Rights in the U.S.: Is the Pendulum Finally Swinging Back to Center?

Nirav Desai, Krishan Thakker, and Charles Wysocki

The U.S. patent system has long struggled to strike a balance that both encourages patent rights and prevents patent abuse. Finding that balance requires giving patent owners the right amount of patent enforcement power, while also giving accused patent infringers the right amount of power to defend against patents. When the patent system gives patent holders too much power, it can lead to a "patent holdup" — where patents, even weak ones, can be acquired and asserted for the sole purpose of extracting money from operating companies. Faced with a system tilted in the patent owner's favor, accused infringers are often too frightened to put up a fight, thereby stifling innovation. But when the patent system gives patent holders too little power, it can lead to "efficient infringement"—where patents, even strong ones, are useless to discourage infringement because infringers view the cost and risk of continued infringement as preferable to acknowledging the patent owner's rights.

Over the last several years, faced with the perception that frivolous patent lawsuits were creating a patent-holdup problem,[1] lawmakers responded with legislation aimed at curbing meritless lawsuits.[2] In parallel, several judicial decisions made enforcement of U.S. patents more challenging for patent owners. This combination of legislation and jurisprudence has led to concerns that the pendulum of U.S. patent rights has swung too far away from patent owners in favor of alleged patent infringers, leading to problems with efficient infringement. Recently, however, new case-law developments may indicate a shift back toward the center, perhaps signaling an appropriate balance between patent rights and the freedom to innovate.

How Did We Get to Patent Holdup and Efficient Infringement?

The terms "non-practicing entity" and "patent troll" have become ubiquitous when describing an entity that acquires patents for the sole purpose of asserting them against companies to extract payment. Such lawsuits can be paralyzing, particularly for nascent and small businesses. Even when the patent is of dubious validity or the accused company does not actually infringe, many companies would settle the case for a fraction of the potential cost of litigation—often called "nuisance-value settlements"—in order to avoid the excessive cost of fighting a patent lawsuit. The potential consequences of fighting and ***losing*** compounded the feeling of being "held up", where a finding of infringement exposes the accused company to an enhanced, punitive damages award—up to triple the amount found by the jury—if infringement is determined to be "willful" or in "bad faith."[3] Additionally, a losing company could be hit with a crippling injunction preventing it from selling the infringing product, further discouraging resistance against even the weakest claims of patent infringement.

The perception was that a patent-troll problem had arisen because the system had become too heavily tilted in favor of patent owners. In response, the legislature and judiciary were prompted to take action. And in the fight to address the patent holdup problem, many legitimate patents—and patent owners—have become collateral damaged.

First, perhaps the crown jewel in the war against patent trolls has been Congress's passage of the America Invents Act ("AIA") on September 16, 2011. When President Obama signed the AIA into law, much of the discussion focused on the shift in the U.S. from a first-to-invent to a first-inventor-to-file patent system. While undoubtedly an important change, the AIA's newly established Patent Trial and Appeal Board ("PTAB") proceedings for challenging the validity of issued patents have had a far more dramatic impact. To date, the PTAB has received around 5,500 petitions from accused infringers and others seeking to invalidate patents in PTAB proceedings.[4] In the early days, the

PTAB established a 90% rate of "institution," the determination of whether to substantively review the patent's validity based on the petition. For instituted petitions, the PTAB initially hit a patent claim "kill" rate of 87%.[5] PTAB proceedings became such a strong weapon for accused infringers, it became commonplace for patent owners asserting their patents to find themselves fighting a losing battle at the PTAB to re-confirm the validity of their patents.

At the same time, several cases issued in the judiciary that compounded the perception that the American patent system had shifted away from patent owners by making it more difficult for patent owners to obtain relief for another company's infringement.

Second, the Supreme Court's triad of *Mayo*,[6] *Myriad Genetics*,[7] and *Alice*,[8] raised the standard for patent eligibility applied when obtaining a patent or defending the validity of an existing patent. U.S. patent law has long held that certain subject matter, such as abstract ideas and laws of nature, are not patent-eligible subject matter. Since issuing, these three decisions have been widely applied, by U.S. federal courts and the U.S. Patent Office, to limit what is considered patent-eligible subject matter.[9] *Mayo* established a two-part framework in determining patent eligibility: (1) whether the claims are directed to a patent-ineligible concept; and (2) whether the claim's elements, considered both individually and as an ordered combination, transform the nature of the claims into a patent-eligible application.[10] *Myriad* applied *Mayo* and found an isolated DNA molecule claimed by the sequence of the encoded protein to be ineligible, ruling that merely isolating the claimed DNA did not render it "markedly different."[11] Then in *Alice*, the U.S. Supreme Court applied *Mayo* in the software space and ruled that merely implementing an abstract idea (*i.e.* an algorithm for eliminating settlement risks) on a generic computer is not "enough" to transform a patent-ineligible idea into patent-eligible subject matter.[12]

Third, the Federal Circuit's *In re Seagate*[13] decision heightened the standard to obtain enhanced damages when infringement was determined to be willful. In *Seagate*, the Federal Circuit outlined a two-prong test for willfulness that required clear and convincing evidence: (1) "that the infringer acted despite an objectively high likelihood that its actions constituted infringement of a valid patent" and (2) that the infringer had knowledge (or should have known) of this risk.[14] Following the high bar set in *Seagate*, many lower courts declined to enhance damages awards, even under the most egregious circumstances, finding that the infringement did not satisfy the two pronged analysis and, therefore, was not legally willful.[15]

The AIA and these cases resulted in a profound shift in U.S. patent law to the opposite extreme, making patent holdup much less likely to occur, but also encouraging efficient infringement. The pendulum of the American patent system appeared to have swung to the opposite end of the spectrum: away from patent owners and toward accused infringers.

Where Are We Now? – Finding a Balance

Over the past several months, the U.S. Supreme Court and Federal Circuit have released pivotal decisions in five cases that may signal a shift in the pendulum of patent rights toward a greater balance between patent owners and operating companies, potentially discouraging both patent holdup and efficient infringement.

First, in the recent case of *In re Magnum Oil*, the Federal Circuit issued a rare reversal in favor of the patent owner of a PTAB *inter partes* review decision.[16] The appeals court found that the PTAB failed to provide a sufficient explanation for its determination that Magnum Oil's fracking technology patent was obvious.[17] It held that the PTAB's ruling was based on "a legally incorrect standard for assessing obviousness," because "the Board erred in shifting the burden of proof [and persuasion] on obviousness" from the patent challenger to the patent owner.[18] Given how statistically rare it has been in the past for the Federal Circuit to reverse a PTAB finding against a patent owner,[19] *In re Magnum* is a signpost that the pendulum may be swinging back towards neutrality. Consistently, recent PTAB proceeding statistics reflect a greater balance between patent owners and challengers. The PTAB institution rate has steadily declined over the past three years from the initial 90% rate to under 70% for all cases in the first-to-third quarters of 2016.[20,21] Although somewhat encouraging, the

statistics still indicate that patent owners have an uphill battle when defending their patents at the PTAB.

Second, the Federal Circuit's triad of decisions in *Enfish*, *Bascom*, and *McRO Inc. a/k/a Planet Blue* provide guidance that could help save software patents from invalidation under *Alice*. In *Enfish*, the Federal Circuit was asked to determine whether a self-referential data table constituted patent-eligible software under 35 U.S.C. § 101. After applying *Alice's* two-step analysis, the panel ruled that it did.[22] The panel construed the first step of *Alice* to ask "whether the focus of the claims is on the *specific asserted improvement in computer capabilities* [or '*computer functionality*'] (*i.e.,* the self-referential table for a computer database) or, instead, on a process that qualifies as an 'abstract idea' for which computers are invoked merely as a tool."[23] In its holding, the Federal Circuit recognized that software patents can be deemed patent eligible even if the invention is run on a general purpose computer and the improvement is not defined by reference to "physical components."[24]

The *Enfish* decision clarified that *Alice's* step-one inquiry is not superficial.[25] The opinion states that one "cannot simply ask whether the claims involve a patent-ineligible concept."[26] Rather, the proper analysis of the claims requires a determination of "whether 'their character as a whole is directed to excluded subject matter.'"[27] *Enfish* serves to define the boundary and limitations of *Alice*'s test. By clarifying the *Alice* test and offering direction on how to employ step one of the analysis, *Enfish* provides much needed guidance for patent owners faced with an unwarranted *Alice* challenge to patents clearly directed to eligible subject matter.[28]

Then came the Federal Circuit's decision in *Bascom*,[29] applying *Alice's* two-step analysis to a web-content filtering patent.[30] *Bascom* confirmed *Enfish* and its application regarding the first step of *Alice*.[31] In this first step, the *Bascom* Court ruled the patented invention was directed to the abstract idea of "filtering [Internet] content."[32] *Bascom* also clarified that *Alice's* second step of the "inventive concept inquiry requires more than recognizing that each claim element, by itself, was known in the art," and that "an inventive concept can be found in the non-conventional and non-generic arrangement of known, conventional pieces."[33] Applying that standard, the Federal Circuit held that the second step of *Alice* was satisfied because it "represents a 'software-based invention[ ] that improve[s] the performance of the computer system itself.'"[34] Thus, a mere recitation that each of the claim elements is "well-understood, routine, and conventional" should no longer suffice and any step-two analysis should analyze how the claims as a whole work together in the claimed invention.

Finally, the Federal Circuit's *Planet Blue*[35] decision is the latest in the series to cut back against the expansive reading of the judicial exceptions in the Supreme Court's *Mayo/Myriad/Alice* triad. *Planet Blue* reversed a district courts' application of the point-of-novelty test,[36] and held an automated process of producing a speaking computer animation as patent eligible subject matter under *Alice*. In applying its *Enfish* decision to the *Alice* step-one analysis (without reaching step two), the Court held that a particular description of an ordered set of claimed steps that use "unconventional" rules for automating the process of animating the face of a character who is speaking is not directed to an abstract idea.[37] The court also noted that McRO's patent is "focused on a specific asserted improvement in computer animation," namely the automatic use of particular rules for animating a character's mouth, and that the claimed invention does not simply use a computer as a tool to automate a conventional activity because the automated process is different from that used by the animators.[38] Given the decisions' heavy focus on claim language and how it is analyzed, *Planet Blue* will likely be widely cited by patent owners of software inventions defending against *Alice* challenges and generic § 101 rejections that ignore express claim limitations, as it helps clarify what makes software patents eligible.

Third, in *Halo*,[39] the Supreme Court confronted the Federal Circuit's *Seagate* decision and overturned the stringent test previously used to determine whether to award enhanced damages. Despite a jury verdict of willful infringement, the district court declined to award treble damages on the grounds that Plaintiffs had not met their burden of showing that the Defendants were "objective reckless[]" under the *Seagate* standard (*i.e.* the district court ruled that the Defendants presented reasonable defenses at trial, like obviousness, that were not baseless). Halo appealed, arguing that the *Seagate* test was too rigid and did not align with the Patent Act. The Supreme Court agreed, overturning the

Seagate test, stating that the two-prong test requiring evidence that the infringer acted despite an objectively high likelihood that its actions constituted infringement with knowledge of the risk did not comport with the language of the statute.[40] Specifically, the Supreme Court made clear that "[t]he subjective willfulness of a patent infringer, intentional or knowing, may warrant enhanced damages, without regard to whether his infringement was objectively reckless."[41] The Court also rejected the *clear* and convincing evidence standard for awards of enhanced damages, finding that the statute imposes no specific evidentiary burden, much less a high one.[42]

While enhanced damages are by no means automatic, following *Halo*, district courts may exercise greater discretion when determining which cases qualify for enhanced damages.[43] *Halo's* decision benefits patent owners by making an enhanced damages finding more attainable and increasing the likelihood that a judge will award enhanced damages in egregious cases, as they are no longer bound by *Seagate's* rigid framework.[44]

Where Are We Going? In response to a perceived patent holdup problem, it has been tough going for U.S. patent owners during recent years—with legislation, the courts, and the PTAB all causing uncertainty over validity and enforcement of patents. Patent owners have complained that the swing in patent rights has reduced the incentives for alleged infringers to respect patent rights, pushed down patent values, and created an efficient infringement problem. Recently though, things appear to be shifting back to neutral. Though there is still a ways to go, the U.S. patent system may soon strike the right balance between patent rights and the freedom to operate, ultimately discouraging both patent holdup and efficient infringement.

For more information, please contact:

Nirav Desai, Director
NDesai@skgf.com

Krishan Thakker, Associate
KThakker@skgf.com

Special thanks to Summer Associate Charles Wysocki for his role as a contributing author of this client alert.

---

[1] *This American Life, "441: When Patents Attack" (July 22, 2011), recording available at: http://www.thisamericanlife.org/radio-archives/episode/441/when-patents-attack; transcript available at: http://www.thisamericanlife.org/radio-archives/episode/441/transcript.*

[2] *See, e.g., Amendments to the Federal Rules of Civil Procedure, adopted by the Supreme Court on April 29, 2015 (available at www.supremecourt.gov/orders/courtorders/frcv15(update)_1823.pdf) at p. 28 (abrogating Fed. R. Civ. P. 84) (effective December 1, 2015); see also H.R. 9 Amendment to 35 U.S.C. § 285(c)(3), Report No. 114–235, Union Calendar No. 177, 114th Congress 1st Session (reported in House on 7/29/15 and hearings held on 2/25/16 in Committee on Small Business and Entrepreneurship); S. 1137 Amendment to 35 U.S.C. § 285(a), Calendar No. 203, 114th Congress 1st Session (reported to Senate on 9/8/15 and hearings held on 2/25/16 in Committee on Small Business and Entrepreneurship).*

[3] 35 U.S.C.A. § 284. *See also i4i Ltd. P'ship v. Microsoft Corp.,* 598 F.3d 831, 860 (Fed. Cir. 2010), aff'd, 131 S. Ct. 2238 (2011) (assessing punitive damages after finding that the defendant "was aware of the asserted patent, but nonetheless acted despite an objectively high likelihood that its actions constituted infringement of a valid patent").

[4] Sterne Kessler's internal statistics show that since September 16, 2012 and through August 31, 2016, 4,993 IPR, 474 CBM, and 33 PGR petitions have been filed (averaging 140 petitions/month in 2016, slightly up from 2015 levels).

[5] *See* http://www.uspto.gov/sites/default/files/documents/2016-4-30%20PTAB.pdf. These statistics were calculated by comparing the total number of PTAB institution decisions with the total number of petitions filed. We used the data provided by the USPTO current as of 4/30/2016.

[6] *Mayo Collaborative Servs. v. Prometheus Labs., Inc.,* 132 S. Ct. 1289 (2012).

[7]*Ass'n for Molecular Pathology v. Myriad Genetics, Inc.,* 133 S. Ct. 2107 (2013).
[8]*Alice Corp. Pty. v. CLS Bank Int'l,* 134 S. Ct. 2347 (2014).
[9]*See* Jorge A. Goldstein, Michelle K. Holoubek, & Krishan Y. Thakker, *The Time Has Come To Amend* 35 U.S.C. § 101, 44 AIPLA Q.J. 171, 174–186 (2016) (discussing the present, unworkable, legal situation created by the current § 101 and applicable case law).
[10]*Mayo,* 132 S. Ct. at 1294-1297.
[11]*Myriad,* 133 S. Ct. at 2117-2118 ("Myriad['s] . . . claim is concerned primarily with the information contained in the genetic *sequence*, not with the specific chemical composition of a particular molecule."); *id.* at 2109 (holding that "Myriad's DNA claim falls within the law of nature exception.")
[12]*Alice Corp. Pty. Ltd. v. CLS Bank Intern.,* 134 S. Ct. 2347, 2353, 2356-57, 2360 (2014).
[13]*In re Seagate Tech., LLC,* 497 F.3d 1360, 1366 (Fed. Cir. 2007).
[14]*Id.* at 1371.
[15]*See, e.g.,* Judgment, *Smith & Nephew, Inc. v. Arthrex, Inc.,* 3-04-cv-00029 (D. Or. July 30, 2011); Jury Verdict, *Convolve, Inc. v. Dell, Inc.*, 2-08-cv-00244 (E.D. Tex. July 26, 2011); Jury Verdict, *Envtl. Mfg. Solutions, L.L.C. v. Peach State Labs, Inc.,* 6-09-cv-00395 (M.D. Fla. Apr. 18, 2011); Judgment, *FURminator, Inc. v. Munchkin Inc.,* 4-08-cv-00367 (E.D. Mo. Mar. 30, 2011); Jury Special Verdict, *Accentra Inc. v. Staples, Inc.,* 2-07-cv-05862 (C.D. Cal. Dec. 21, 2010).
[16]*In re Magnum Oil Tools Int'l, Ltd.,* 2016 WL 3974202 (Fed. Cir. July 25, 2016).
[17]*Id.*
[18]*Id.* (citing 35 U.S.C. § 316(e); see also *Nike, Inc. v. Adidas AG,* 812 F.3d 1326, 1334 (Fed. Cir. 2016)).
[19]Sterne Kessler's internal statistics reflect that, as of August 15, 2016, the Federal Circuit had docketed more than 700 appeals of final written decisions made by the PTAB in IPR cases (623) and CBM reviews (90), the vast majority of which are pursued by patent owners (i.e. over 75%). To date, the Federal Circuit has reached decisions in 134 of those cases (35% comprising of Rule 36 summary affirmances), with only 10 reversals of the PTAB ruling. Thus, parties seeking to challenge the validity of patents in AIA proceedings have an outstanding track record of success, with at least one challenged claim being invalidated in approximately 85% of final written decisions at the PTAB and more than an 80% chance of patent owners gaining an affirmation at the Federal Circuit level. According to recent published statistics from the USPTO, 928 of 1086 (85%) IPR final written decisions have invalidated at least one challenged claim, and in 764 of 1,086 IPR final written decisions (70%), all instituted claims have been found invalid. The numbers are even more favorable to petitioners in CBM proceedings. See http://www.uspto.gov/sites/default/files/documents/2016-07-31%20PTAB.pdf
[20] *See* http://www.uspto.gov/sites/default/files/documents/2016-4-30%20PTAB.pdf. These statistics were calculated by comparing the total number of PTAB institution decisions with the total number of petitions filed. We used the data provided by the USPTO current as of 4/30/2016.
[21] Sterne Kessler's internal statistics show the PTAB granted institution of trial in 86% of decisions in the PTAB's first year of existence. In the past calendar year, the PTAB has instituted trial in 2/3 of the petitions on which it rules. Additionally, our internal statistics show that the institution rate has stabilized over the last 12 months and ranges from 62.5% to 69.1%. But, of those instituted proceedings, cancellation of claims rates are still high, with 81% and 96% of claims being held unpatentable in IPR and CBM final written decisions, respectively.
[22] *Enfish, LLC v. Microsoft Corp.*, 822 F.3d 1327 at 1339 (Fed. Cir. May 12, 2016).
[23]*See id.* at 1336 (emphases added).
[24]*See id.* at 1339.
[25] The Federal Circuit determined that the district court's framing of the claims was improper, using language that will likely be welcome by patent owners and applicants alike: **"describing the claims at such a high level of abstraction and untethered from the language of the claims all but ensures that the exception to §101 swallow the rule."** *See id.* at 1337. (emphases added).
[26]*Id.* at 1335.
[27]*Id.*
[28]For more information on *Enfish*, click here.
[29]*Bascom Global Internet Servs., Inc. v. AT&T Mobility LLC*, 827 F.3d 1341 (Fed. Cir. June 27, 2016).
[30]*Id.* at 1347-1352.
[31]*See, e.g., id.* at 1349 (stating that the "*Enfish* claims, understood in light of their specific limitations, were unambiguously directed to an improvement in computer capabilities") (citing *Enfish*, 2016 WL 2756255 at *5).
[32]*Id.* at 1350-1351.
[33]*Id.* at 1350.
[34]*Id.* at 1351 (stating that the patent "claimed a technical solution to a problem unique to the Internet," namely a "technology-based solution . . . to filter content on the Internet that overcomes existing problems with other Internet filtering systems . . . making it more dynamic and efficient") (citations omitted).
[35]*McRO Inc. v. Bandai Namco Games America Inc. et al.,* 2016 WL 4896481 (Fed. Cir. Sept. 13, 2016)

[36]*McRO, Inc. v. Sega of America, Inc.,* 2014 WL 4749601, at *11 (C.D. Cal. Sept. 22, 2014) (holding that McRo's patents on lip-sync animation technology are invalid using the "point of novelty" test under *Alice* for claiming the abstract idea of using rules to create computer animation).
[37]*McRO v. Bandai Namco,* at *1, *8-10.
[38]*Id.* at *8-9 ("It is the incorporation of the claimed rules, not the use of the computer, that 'improved the existing technological process' by allowing the automation of further tasks," further holding that it was different from the invention in cases like *Alice*, "where the claimed computer-automated process and the prior method were carried out in the same way.")
[39]*Halo Elecs., Inc. v. Pulse Elecs., Inc.,* 136 S.Ct. 1923 (2016).
[40]*Halo Elecs., Inc.,* at 1923-1924 .
[41]*See id.* at 1933.
[42]*See id.* at 1934.
[43]The court directed district courts to take into account the particular circumstances of each case and reserve punishment only for egregious cases typified by willful misconduct. *See id.*
[44]For more information on *Halo*, click here.