

## **Is There Justification for Greater Transparency in Patent Transactions?**

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### *Introduction*

In a recent article<sup>1</sup>, the author argues for the need for greater transparency in the “marketplace” for transactions involving patents. The author points out several inefficiencies that may result from a lack of transparency regarding the holdings of an entity that is seeking to license one or more of its patents. These inefficiencies result from a potential licensee being unable to readily obtain information regarding the complete holdings of the licensor, and the resultant uncertainty that may introduce regarding relevant prior art, other assets of interest, preferred negotiating tactics, etc. In general, the author thinks that the lack of transparency that results from the use of “shell” companies or other methods of disguising the actual owner of an asset create difficulties for the negotiation process, cause a failure to provide “notice” of the real party in interest (which may impact negotiations and legal options, as well as prevent knowledge of the true holdings of an entity), and subjects potential licensees to a situation in which they are at a disadvantage before even beginning a licensing discussion. There has been an increasing amount of discussion and proposed actions related to making information available regarding the entire patent holdings of patent buying entities when they seek to license portions of their patent portfolios.

Although some may argue that a “level playing field” (or at least a more level one) is not necessarily required for every transaction and is not something that a party is entitled to in a marketplace, this article will discuss some of the reasons why it may be beneficial to introduce a more level playing field into the market for patents. Because of the strong public policies that underlie the creation and administration of the patent system, there is a related public interest in how that system is operated. It is my belief that this public interest is sufficient to justify introducing a greater degree of transparency into the “market” for patents. This greater degree of transparency may be achieved via judicial decisions, but may be more effectively introduced through enforcement of competition related laws or new regulations, in order to produce a desired degree of uniformity in how any new requirements are implemented.

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<sup>1</sup>Matt Rappaport, “How Hidden IP Assets Hurt the Entire Patent Community”, IP Law360 (<http://www.law360.com/technology/articles/393963/how-hidden-ip-assets-hurt-the-entire-patent-community>).

## *Why Increased Oversight or Regulation May Be Justified*

While some may argue that patent aggregators, non-practicing entities (NPEs), or patent assertion entities (PAEs) (collectively, “patent buying entities”) represent a business model that is counter-productive to the goals of the patent system or to notions of fairness, such comments seem more of a visceral response or value judgment, rather than a conclusion supported by facts. Instead of arguing about whether such entities should exist, it may be more productive to address the possible consequences of their operational methods when they purchase patents or patent applications. Specifically, how a lack of transparency in their operations can create distortions in the efficient operation of a “market” for patent rights. Even if it is uncertain whether such entities are operating in a manner that is supportive of the goals of the patent system, I believe that there are strong reasons for advocating greater transparency in their operation as this would be expected to establish a more efficient and trustworthy “market” for patents. An additional benefit is that this will also enable a more accurate determination of whether the existence and operation of these entities support, inhibit, or are effectively neutral with respect to achieving the goals of the patent system.

There are strong public policies behind the creation and operation of the patent system and as a result, both the Federal government and the public have an inherent interest in that system. This clear from the concern for providing protection for inventions that is expressed in the U.S. Constitution<sup>2</sup> and the Federal statutes based on that expression<sup>3</sup>. The Federal government has an interest in seeing that the patent system operates in a way that enables the system to achieve its stated purpose(s), while observing its obligations to the public. The public has a similar interest in seeing that the patent system fulfills its stated purpose(s), since the system is operated by the Federal government as a service for the public.

Because of the strong public interest in the operation of the patent system and its impact on the public, I believe that the exchange of patent rights should not be exposed to the benefits and disadvantages of the free market system without a careful consideration of whether additional controls should be applied

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<sup>2</sup> Congress shall have power . . . To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries. U.S. Const., Art. I, Sec. 8.

<sup>3</sup> The Patent Act, 35 U.S.C.

to ensure that the market operates efficiently and fairly for the participants, while supporting (or at least not harming) the interests of the public<sup>4</sup>.

A “market” is being developed for patents and the rights that they enable the owner to exercise. This is shown by the development of patent trading systems, the holding of patent auctions, and the general increase in attention paid to the value of patents as business assets<sup>5</sup>. However, the asset being traded in such a market is of a different nature than most assets. Patents represent a conscious decision by the Federal government to encourage certain types of behavior by members of the public by creating a new type of property. As a result, patents themselves and the operation of the system that grants them are invested with a stronger government and public interest than is the transfer of most other types of property. This suggests that justification exists for a greater degree of scrutiny into whether the operation of entities that engage in the buying, selling, and licensing of patents do so in a way that supports (or at least does not frustrate) achieving the goals of the patent system.

### *Should the Patent “Market” Be Considered Part of the Patent System?*

A threshold issue is whether a marketplace for the transfer of patent assets should be considered as part of the overall patent system, or instead whether it should be considered a part of the free market system (and as such, evaluated independently of its impact on the patent system). The existence of patent aggregators, NPEs, and PAEs would be expected to have at least some impact on the innovation process; such entities provide an additional exit strategy to enable inventors and companies to recoup some portion of their investment in generating the assets. In addition, the ability to sell a patent may enable an inventor to continue working on other projects, which may lead to more innovation. In general, having a marketplace in which patents may be sold is a positive development, as it may prevent a waste of assets, which is typically a desirable outcome. Therefore, it would seem that having this exit strategy would provide an incentive for at least some additional risk taking and investment in innovation.

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<sup>4</sup> Note that examples exist of the introduction of federal oversight to establish greater transparency and a more level playing field in other areas, such as the trading of stocks, in order to provide for a more efficient and trustworthy market. With regards to stock transactions, transparency, disclosure, and insider trading regulations all act to protect the interests of one party in a situation in which an imbalance in information exists.

<sup>5</sup> Patents represent more than a collateral output of the product development cycle. Because of the many possible value propositions for a patent, a properly constructed patent portfolio can effectively protect a company’s assets and in some cases may be used to reduce operating costs or generate revenue.

At the least, it seems disingenuous to say that the existence of such patent buying entities has no impact on the innovation process or other aspects of the patent system. Given that there is at least a possible impact, I believe that there is justification for considering the still-developing market for patent assets as part of an overall patent system that is intended to fulfill specific goals. And, if the existence of that market is part of a system that is supposed to create an incentive for innovation, then it stands to reason that a properly functioning market is desirable in order to ensure a proper level of incentives and to most efficiently produce the desired benefits of those incentives.

Assuming that there is some impact on the patent system and its operation that can be traced to the operations of patent buying entities, what (if anything) should be done about it? Given the possible inefficiencies or distortions in the operation of a market for patents (and the overall patent system) that can result from a lack of transparency, one could simply accept this as a by-product of exposing patent rights to the operation of a free market system. However, because patents are a property right created by the Federal government for a specific purpose, it may be preferable to recognize a strong enough public interest in the operation of the market for patent rights to justify considering additional controls that would increase the transparency in transactions that occur within that market. This approach seems desirable for at least two reasons: (1) until we can be more certain that such patent buying entities are not having an undesirable impact on the patent system, it is more likely to be in the public interest to err on the side of increased transparency rather than decreased transparency; and (2) since the overall patent system is one designed around establishing and fostering incentives to innovate, it is expected that greater transparency would be more conducive to achieving the proper incentives than would less transparency. If controls that functioned to increase transparency were to be adopted, then such controls would assist in ensuring that the proper incentive structure was in place for an efficiently operating market, and one which presumably would operate more effectively in achieving the goals of the patent system.

#### *Arguments for Increased Buy-Side Transparency*

As noted, the article referred to in the Introduction discusses some of the problems caused by a lack of transparency in the patent licensing operations conducted by patent aggregators, NPEs, and PAEs. However, there is another

aspect of the use of shell companies and other factors that reduce transparency that may impact the proper operation of a marketplace for patent assets. This is the impact such a practice has on the buying side operations of these entities; specifically, how a lack of transparency may distort the operation of a market for patents, including by preventing a more accurate valuation of patents. The lack of an accurate valuation (or at least the existence of obstacles to a more accurate valuation) does not serve the interests of those selling patents or those to whom they have a fiduciary obligation (such as venture capital investors or stockholders in a company that is selling some of its patent assets).

For example, by using shell companies and preventing disclosure of the ultimate purchaser (and in some cases the beneficiaries of a purchase) of a patent portfolio, a patent buying entity is allowed to distort the market for the value of the rights they are negotiating to purchase. This is because an inventor or other potential seller of a patent portfolio has a reduced amount of information about who wants to buy their patents and what previously existing agreements are in place between the buyer and other parties. For example, such agreements might result in the buyer granting a license to a party that might have paid much more for the patents if the seller had negotiated with them directly.

In the case of the seller being an operating company, such agreements may cause the undesired result of granting a license to a competitor with whom the company would have rather negotiated in an effort to obtain an agreement of greater value to the company (such as a joint development agreement, co-marketing agreement, more desirable distribution terms, a patent cross-license, etc.). The use of a shell company and the failure to disclose existing agreements that may impact the licensing of a purchased patent portfolio may therefore place the seller at a severe disadvantage during negotiations. In addition, due to the lack of transparency, a seller is unable to evaluate how their patents fit into the overall holdings of the prospective buyer. This is likely to further impact the seller's appreciation of the potential value of their own patents to the buyer. Investors in a selling company may not recapture the full value of a patent that resulted from a company's investment in research and development (R&D) if the market value for a patent is distorted. Thus, it is in the interests of the investors of the selling company to have increased transparency since it impacts the valuation of the company and may impact how investors view the decisions made by the executives of the company.

The seller's lack of knowledge regarding the actual buyer and any possible beneficiaries of the sale of their patents prevents them from determining the true

demand for their asset, and hence its actual value in the marketplace. As is the case with a lack of transparency in other markets, this distorts the valuation of the assets being exchanged and introduces inefficiencies into the operation of a market for such assets. However, in contrast with transactions involving other goods, the lack of transparency may also introduce a need for greater oversight in order to protect the public interest and prevent unfair and/or anti-competitive business practices that act to prevent (or at least lessen) the ability to achieve the goals of the patent system.

Increased oversight may be provided by one or more suitable mechanisms. These include interpreting unfair competition laws to require disclosure of the actual purchaser and any expected beneficiaries of the purchase of a patent portfolio, or by the establishment of new requirements on the transfer of patents as part of the Federal laws that establish and regulate the operation of the patent system. Judicial action may also be used, such as where a Court decides that proper valuation of a patent cannot be determined without knowledge concerning the actual purchaser and its holdings, or that the validity of a patent that is being asserted cannot be determined without knowing the full holdings of the party asserting the patent.

#### *Other Operational Aspects That May Be of Concern*

The previous discussion has focused on the impact of the lack of transparency arising from using shell companies to obscure the actual buyer of a patent and/or beneficiaries of a purchase on the seller of a patent. In addition, there may be other aspects of patent buying entities that should be considered in order to determine if the operations of such entities are supportive of the goals of the patent system.

Consider the situation where a patent buying entity has investors. If the entity is publicly traded, then disclosure obligations will presumably act to make sellers (i.e., inventors or corporations that employs inventors) aware of at least some of the implications of selling their patents to the entity. However, if the entity is private, many of these obligations do not apply and information regarding operational methods may not be available. In such a case, if a patent buying entity has investors, it may be important to know if those investors have input into what portfolios are being bought. This is because such inputs or direction may act to further reduce efficient operation of the market by hiding the interest of those investors in a particular portfolio. This affects valuation because

it prevents a seller from knowing which parties may be most interested in their patents, and hence the potential demand for the assets. It therefore may enable the investors to acquire patents or licenses at less than the true market value of such assets.

More importantly, it may also raise antitrust or unfair competition concerns because the lack of transparency can permit investors to hide behind the buying entity while having their risk exposure to the patent assets reduced. This may reduce competition by (1) permitting investors to cooperate in efforts to reduce their risk by purchasing patents at below market value, and (2) providing the investors with a mechanism for asserting the purchased patents against competitors of the investors. Further, if the investment opportunity in the patent buying entity is not open to all, then those excluded may be at a competitive disadvantage relative to those that are able to invest and exercise some direction over how the patents are asserted. Another benefit to investors in a patent buying entity is that they do not have to make the R&D investment that would typically be required in order to obtain the purchased patents.

Note that even if the “direction” exerted by investors is indirect or informal, it may still amount to a business practice which is unfair or which alters the competitive environment. This is because the patent buying entity would be expected to act in the interests of its investors with regards to which patents to purchase and against which targets to assert those patents. Thus, the type and degree of direction exerted by investors (in a formal or an informal sense) with regards to the purchase and assertion of patents is an aspect of the operation of patent buying entities that may need to be examined.

Regardless of the outcome, it seems appropriate to consider whether the operational behaviors of patent aggregators, NPEs, and PAEs are supportive of (or at least devoid of any negative impact on) achieving the intended goals of the patent system. This would help to ensure that the goals that were intended to be accomplished by the grant of an important Federal right are not being harmed by exposing patents to the operation of the free market system. It may turn out that patent aggregators, NPEs, and PAEs are themselves not the problem, but only that certain aspects of their operations need to be modified.

### *The “Bottom Line”*

Because the Federal government created the rights at issue and intended for them to be used for a specific purpose, it may be necessary to introduce additional controls into the operation of the developing market for patent rights.

If the actions of, or the methods of operating a business that are practiced by, patent aggregators, NPEs, and PAEs are counter-productive to (or even simply unresponsive to) the goals of the patent system, then additional controls may be justified in order to restore the market for patent assets to a more desirable form. If such controls are to be adopted, their form is uncertain but presumably would include fuller disclosure of the entities that would benefit from a purchase of a patent portfolio, such as the actual buying entity and any other parties that would be expected to benefit by having a license to the purchased assets. The controls may also require disclosure of the investors in a patent buying entity and the ways in which investors may impact the acquisition or assertion of patents.

While other markets may accept a similar lack of transparency (and the resulting inequities) as part of the free market process, such an approach may be inappropriate where patents are concerned. At the least, it seems desirable to determine if the lack of transparency being practiced by certain patent buying entities is having an undesired impact on the operation of the patent system.