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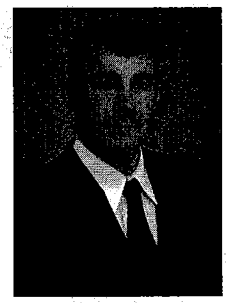
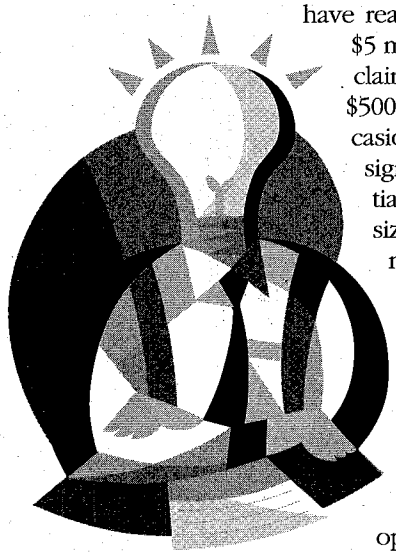
Intellectual Property Insurance: Transforming the Economic Model for IP Litigation

Inherently, a patent is insurance. It is a government-granted right to exclusively produce, use, or sell products covered by that patent. Essentially, the patent provides insurance that nobody else will have this right. But some innovative companies—and especially those with patent assertion business models—rely on independently provided intellectual property insurance for protection from infringement and the costs associated with it. Although litigation insurance is not new, the growth of intellectual property insurance in the past decade warrants a consideration of the benefits and disadvantages associated with this model, as well as its effect on the IP litigation landscape. At minimum, it is worth noting that the number of companies acquiring IP insurance is increasing. Clients should be aware that this opportunity exists, and they should also be aware that potential opposing parties in litigation may have IP insurance policies in their pockets.



The cost of IP litigation has become notorious over the past decade. In some sectors, such as biotechnology, up to 6 percent of patents become the subject of litigation during their lives.[1] Some highly innovative companies create litigation budgets equaling up to 25 percent of their R&D costs.[2] According to the American Intellectual Property Law Association, large-case (between $1 million and $25 million at risk) costs have reached an average of $3 million to $5 million per party, depending on the claims involved, and have reached the $500 million mark on at least one occasion.[3] The high price has become a significant factor in settlement negotiations. As a result, small to medium-sized firms are deterred from entering markets saturated with companies boasting large patent portfolios and deep pockets. A single infringement claim filed against a start-up small to medium-sized firm that lacks sufficient capital to fight the claim could effectively close down the company. Consequently, these firms' precious operating capital becomes defense funds for IP litigation, and the firms never get around to commercializing their special product. In sum, the barrier to entry becomes insurmountable simply because the price tag for playing is too high. The 30,000-foot view is that this barrier to entry creates a monopolizing effect for those with larger purses. But IP insurance aims to provide a balanced playing field.



Companies offering IP insurance generally offer two different policies: IP defense insurance for companies that wish to insure their IP assets against future infringement claims, and IP abatement insurance (offensive IP insurance) for companies looking for a stronger position in enforcing their IP assets.

IP Defense Insurance

Of course, the benefits of owning IP defense insurance in the face of a patent infringement claim are obvious. Being insured means that (1) the defendant may have sufficient funds to support a strong legal front, thereby increasing the likelihood of a favorable outcome; (2) a company doesn't have to rely on operating funds or other capital to defend itself; and (3) a company with less capital and a stronger legal position doesn't have to succumb to the pressure of settling or licensing. This last benefit is extremely important and deserves further comment. The frequently used fallback position of a defendant without the means to litigate a case adequately is settlement. After all, compromise is the rational choice when the risk of losing everything is involved, and like every type of litigation, certainties don't exist in IP litigation. The unequal positions in the cost-benefit analysis are frequently exploited by those companies that have deeper pockets and are already occupying the market. The understated effect of owning IP defense insurance, however, is the ability of that asset to ironically take the money factor off the bargaining table and let legal positions talk. This outcome effectively helps create a result—whether through litigation or settlement—that more closely mirrors the legal merits of the situation, rather than the size of the bank accounts involved.

The particular value of IP defense insurance to small innovative companies has been well documented. In 2003, the European Union briefly entertained introducing a compulsory patent insurance scheme. According to one study of the effect of patent insurance across international patent systems, the benefits of obtaining patent insurance in the United States is greater than in all other countries, because monopoly profits are relatively small whereas litigation costs are overwhelmingly large.[4] Even though outlying factors make the beneficial ownership of an IP insurance policy an ad

hoc cost-benefit analysis—including the price of the deductible—it has become an asset that firms in certain litigious markets are increasingly examining.

IP Abatement Insurance

Based on a basic legal and economics model, IP abatement insurance has the potential to afford a stronger negotiation position and increase licensability of IP assets because it (1) creates the potential to reduce the pressure to settle because of a limited resource of funds; (2) may discourage potential infringement by demonstrating the financial ability to enforce rights to intellectual property; (3) could help maintain market share by allowing for quicker decisions and actions with respect to potential infringers; and (4) has the tendency to increase the value of intellectual property because that value is intrinsically tied to the quality of intellectual property, which is inherently tied to enforceability. Like IP defense insurance, the benefits and effects of IP abatement insurance have been studied. One study has gone so far as to conclude that, for an innovative company already holding some market share, and with all other factors remaining constant, obtaining IP abatement insurance always provides more utility to the company than not obtaining insurance.[5] As mentioned above, however, the truly interesting upshot is that IP abatement insurance has the tendency to increase the market value of intellectual property in the hands of its owner. After all, the value of intellectual property is unequivocally tied to the quality of the IP, and IP quality is the sum of the market opportunity for the IP and its defensibility or presumption of validity. One factor in measuring the defensibility of a patent in the hands of its owner is the amount of money the owner is capable of spending to enforce its IP rights. Of course, owning IP abatement insurance increases this factor, which implicitly raises the presumption of validity for that intellectual property, in turn enhancing the quality and value of the IP.

The benefits of IP insurance to certain innovative companies are real, depending on their portfolio and market position, but the merits of the model of subsidizing litigation and incentivizing settlement negotiations are yet to be completely examined. The IP insurance market is still somewhat new—and it is growing. Surely, there will be debate about whether insurance will give false courage to those in weaker legal positions, thereby creating what has been termed "excessive litigation." On the other hand, IP insurance has the potential to create an even playing field and balance the seesaw of bargaining positions, thereby letting legal sufficiency talk instead of pocketbooks. In this light, IP insurance could have a deterring effect on litigation, positively affecting the marketplace for IP because, as stated above, IP insurance has the potential to enhance licensability and thereby increase the frequency of IP transactions.

In sum, it may be prudent to simply advise clients that intellectual property insurance is available. Moreover, that advice could be just as helpful if it is given only to help a client realize that the other side may be insured, and a foray into litigation could turn into a "be careful what you wish for" situation. **TFL**

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Endnotes

[1]Garard Llobet and Javier Suarez, *Patent Litigation and the Role of Enforcement Insurance* (2008), available at www.cemfi.es/~llobet/PLpaper.pdf (last visited May 24, 2010).

[2]*Id.*

[3]Alan Ratliff, presentation to the In-House Counsel Institute on Damages, AIPLA (American Intellectual Property Law Association) Annual Meeting (2007), available at www.aipla.org/Content/ContentGroups/Speaker_Papers/Annual_Meeting_Speaker_Papers/200717/Ratliff-paper.pdf (last visited May 24, 2010).

[4]Llobet and Suarez, *supra* note 1.

[5]*Id.* at 25–26.

CYBERIA *continued from page 17*

preinstalled software that becomes available when a user creates a profile on a new device.

Conclusion

It is better to be safe than sorry, to be sure. Clearly, some of the above-mentioned solutions provide much more protection than others, but *every lawyer who leaves his or her office door open at night should erect at least some sort of anti-information-theft barrier.* It can be very cold out there in Cyberia, as my colleague with the missing iPhone quickly discovered! See you next issue. **TFL**

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