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The Heightened Domestic-Industry Standard for NPEs

By Reza Mirzaie and Irfan A. Lateef – September 12, 2012

Historically, the International Trade Commission (ITC) has been viewed as the federal agency charged with protecting domestic manufacturing entities from unfair international trade activities, such as the importation of articles that infringe a U.S. patent. To this end, Section 337 of the Tariff Act of 1930, the statute that created the ITC, has always required that ITC complainants show they have a "domestic industry" relating to their patent. Initially, this requirement essentially forced ITC complainants to show they made substantial investments relating to the domestic manufacturing of articles covered by the patent. As a result, holders of U.S. patent rights that do not make any products, often referred to as nonpracticing entities (NPEs), were virtually excluded from seeking ITC relief.

In 1988, however, Congress changed the domestic-industry requirement to open the ITC's doors to some NPEs, provided that the NPEs show a substantial investment in nonmanufacturing "exploitation" of their patents, which includes licensing their patent rights to others. With the rise of NPE patent litigation in the last decade, many NPEs—including those that purchase patent rights for the purpose of enforcing them against manufacturing entities—have sought out the broad exclusionary relief available in the ITC. As a result, courts have had to interpret and apply the amended domestic-industry requirement for NPEs.

Over time, the ITC has set and followed certain trends in deciding which NPE activities are sufficient to show substantial investment in licensing as required under Section 337. Early on, the ITC set forth a seemingly low standard for NPEs to satisfy. Not surprisingly, this resulted in a rise in NPE litigation in the ITC. But more recently, the ITC has clarified and, in fact, raised the standard. As a result, NPEs today must seriously weigh the benefits of seeking ITC relief against the potential risks of failing to prove the domestic-industry requirement.

How the ITC Evolved to Become a Viable Forum for NPEs

Before the creation of the ITC, patentees in the United States could only bring an infringement action in federal district court, but the onset of globalization and the corresponding rise in importation of foreign-made articles created a need for a mechanism to inhibit imported products from infringing U.S. patents. Congress, which has the unique power to both "promote the Progress of Science" and regulate commerce, responded to this need by enacting Section 337 of the Tariff Act of 1930. Over time, that legislation gave the ITC the ability to investigate complaints regarding the alleged importation, sale for importation, and sale after importation into the United States of articles that infringed a valid, enforceable U.S. patent. If the ITC finds that such unlawful activities have taken place, it can give relief to a patentee complainant by issuing an exclusion order to prohibit the importation of the infringing articles.

Unlike district court, however, not all patentees can file an action in the ITC. Rather, to prevail in an action under Section 337, a patentee must show that it has a requisite "domestic industry." The domestic-industry requirement requires a patentee to satisfy a technical prong and an

economic prong. The technical prong requires patentees to show that their domestic investment relates to the technology claimed in their asserted patents. Before 1988, the economic prong required patentees to show a direct injury to their "efficiently and economically" operated industry in the United States. *See* Smoot-Hawley Tariff Act of 1930, Pub. L. No. 71-361, § 337(a), 46 Stat. 730 (codified as amended at 19 U.S.C. § 1337 (2006)). Patentees likewise were required to show substantial activity that employed the use of American land, labor, and capital. During this time, critics of the statute felt that the requirements under the economic prong made it too difficult for most patentees to bring an action under Section 337 and, consequently, placed too little value on protecting U.S. patent rights in the context of international trade.

In 1988, Congress answered the critics' call by amending Section 337 to lower the threshold for meeting the domestic-industry requirement. In so doing, Congress paved the way for NPEs to bring infringement actions in the ITC. Under the 1988 amendments, which are still in effect today, Congress eliminated the requirement that asked patentees to show a direct injury to an "efficiently and economically operated" domestic industry. *See* Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1342, 102 Stat. 1107, 1213. Congress also clarified that patentees could satisfy the economic prong by showing that they have made a "(A) significant investment in domestic plants and equipment; (B) significant employment of labor or capital; or (C) substantial investment in . . . *exploitation, including* engineering, research and development, or *licensing*." 19 U.S.C. § 1337(a)(3) (emphasis added). As a result, NPEs—which, under the previous statute, could not show an efficiently and economically operated industry that utilized American land, labor, and capital—could now satisfy the economic prong by showing substantial investment in licensing any patents they wished to assert.

The legislative history behind the 1988 amendments suggests that Congress intended to open the ITC's doors to some, but not all, NPEs. In particular, House and Senate reports expressly state that the amendments were intended to provide relief under Section 337 to "universities and other intellectual property owners who engage in extensive licensing of their rights to manufacturers." S. Rep. No. 100-71, at 129 (1987). But other parts of the legislative history reveal that Congress did not aim to extend such relief to just any patent holder. For example, Congress explained that the statute was never intended to protect holders of U.S. patent rights who have only limited contact with the United States and, therefore, the amendments should not be used as a loophole to the domestic-industry requirement. Congress also stated that the amendment covers those "actively engaged in steps leading to the exploitation of the intellectual property, including application engineering, design work, or other such activities." H.R. Rep. No. 100-40 pt. 1, at 157 (1987). Thus, even under the 1988 amendments, Congress intended to limit the protection of Section 337 to those entities that made a substantial investment in domestic innovation or licensing to others for the purposes of domestic manufacturing.

The Seemingly Relaxed Domestic-Industry Requirement for NPEs

Notwithstanding the changes in the domestic-industry requirement, the ITC remained a seldom-used forum for NPEs for many years after the 1988 amendments, but with the rise of NPE litigation in the mid-2000s, several NPEs began testing the waters in the ITC. Around this time,

the ITC handed down a number of decisions that appeared to set a relatively low bar for NPEs to meet the domestic-industry requirement.

In 2009, for example, in *Certain Short-Wavelength Light Emitting Diodes, Laser Diodes, and Products Containing the Same*, Inv. No. 337-TA-640, Order No. 72 (May 8, 2009), the complainant, Professor Gertrude Rothschild, moved for summary determination that she met the economic prong through her licensing and litigation efforts. Rothschild argued that her litigation activities in district court showed "a substantial investment in enforcing her patent and furthering her licensing program." *Id*.at 55–57. She also argued that her few licensees had made a substantial investment in manufacturing and research and development, which was sufficient to satisfy the economic prong. The administrative law judge (ALJ) agreed, finding that Rothschild's licensing activity was sufficient to satisfy the economic prong and that she also showed proof of substantial investment through the payment of legal fees for her district-court litigation and related licensing efforts.

Later that year, in *Certain Electronic Devices, Including Handheld Wireless Communications Devices*, Inv. Nos. 337-TA-673 and 667, Order No. 49C (Oct. 15, 2009), another NPE complainant, Saxon Innovations LLC, also moved for summary determination that it satisfied the economic prong. The ALJ in that investigation granted the motion notwithstanding that Saxon had only five employees and a business model arguably focused on purchasing patents and asserting them against potential infringers. To meet its burden in the motion, Saxon relied on the activities of its sole licensee, Motorola, to whom Saxon licensed the asserted patents more than 10 years prior to filing its complaint. The ALJ agreed with Saxon's argument and found that Motorola's activities relating to the patented articles were sufficient to satisfy the domestic-industry requirement. Moreover, the ALJ rejected the respondents' argument that Saxon could not meet the economic prong because it only generated licensing revenue years before the complaint was filed and did not generate a current stream of licensing revenue. The ALJ held that Saxon did not have to show a current revenue stream because Saxon was relying on the investment and activities of its licensee instead of its own licensing activity to meet the economic prong.

In light of the then-apparent trend in setting a low threshold to satisfy the domestic-industry requirement, NPEs, including foreign-based NPEs, began filing ITC complaints in unprecedented numbers. For example, while an average of four NPEs filed ITC complaints annually between 2006 and 2009, 16 NPEs filed such complaints last year. This is not surprising given that ITC litigation provides patentees with several strategic benefits over district-court litigation. These advantages include, most notably, a quicker pace from filing the complaint to trial and injunctive relief that is essentially automatic if the patentee shows an unlawful importation of infringing articles. (In the past, injunctive relief was likewise regularly granted in district court after a finding of infringement, but the 2006 Supreme Court decision in *eBay, Inc. v. MercExchange, LLC*, 547 U.S. 388, 393 (2006), changed this regime by requiring district courts to apply a more stringent test for granting injunctive relief after a finding of infringement.) Now that the ITC appeared to welcome NPE complainants into its courts, why not take advantage of its strategic benefits?

Recent Decisions Make It Tougher to Meet the Domestic-Industry Requirement
Perhaps in reaction to the anticipated rise of NPE litigation in the ITC, recent decisions have scaled back the seemingly relaxed standards set forth in pre-2010 decisions. In *Certain Coaxial Cable Connectors and Components Thereof and Products Containing Same,* Inv. No. 337-TA-650, Comm'n Op. (March 31, 2010), the complainant, PPC, filed a complaint to exclude the importation of all coaxial cables and connectors that infringed its design and utility patents. Because PPC did not practice its design patent, it tried to satisfy the domestic-industry requirement by showing a substantial investment in the exploitation of its patent through its licensing activities. Specifically, PPC argued that its past litigation expenses, incurred in pursuing three separate district court actions against the respondent and the respondent's distributor, were sufficient to show such substantial investment. The ITC rejected PPC's argument, holding that expenditures on patent litigation do not automatically constitute evidence of a substantial investment in the exploitation of a patent. Thus, the ITC held that PPC failed to show a proper nexus between its litigation expenses and a substantial investment in licensing the asserted design patent. PPC appealed to the Federal Circuit, the appellate court tasked with reviewing appeals from final determinations in the ITC.

In a 2011 opinion, a majority panel in the Federal Circuit agreed with the ITC and held that PPC's litigation expenditures were not sufficiently tied to the licensing of the asserted design patent. *John Mezzalingua Assocs., Inc., v. Int'l Trade Comm'n*, 660 F.3d 1322, 1331 (Fed. Cir. 2011). First, the Federal Circuit held that PPC did not engage in sufficient pre-litigation licensing efforts but decided to file infringement suits in lieu of such efforts. Then, the Federal Circuit reached the same conclusion with respect to PPC's post-filing licensing activities during the litigation. On this issue, the court held that the entirety of PPC's district-court litigation expenses could not be relevant to the domestic industry question because some of that litigation did not involve the asserted design patent. With respect to the litigation activities that did involve the asserted design patent, the Federal Circuit held that PPC's expenses did not amount to a "substantial investment" in licensing. The record showed that PPC's litigation resulted in only one executed license, which was only partly related to the design patent. And PPC never formally offered a license to the asserted patent during the litigation. To the contrary, it waited two full years after obtaining a district-court injunction against the respondent before seeking and obtaining that license. These facts indicated that PPC's purpose in litigating "was not to obtain a license but, rather, was to stop [the respondent] from manufacturing infringing connectors." *Id*. at 1329. Therefore, the Federal Circuit held that the ITC was entitled to conclude that the litigation expenses should not be credited as expenses related to licensing under the economic prong.

The Federal Circuit further stated that, outside of the litigation context, "PPC had no formal licensing program and that there was no evidence it had offered to license the patent to any party other than its litigation opponents." *Id*.at 1330. Here, the court did caution that "there is no rule that a single license—such as an exclusive license—cannot satisfy the domestic industry requirement based on a substantial investment in licensing." Nevertheless, based on the evidentiary record, the court held that the ALJ "was entitled to view the absence of other licenses issued or negotiated for the [asserted] design patent as one factor supporting his conclusion that

PPC's expenditures related to licensing were not substantial."The Federal Circuit concluded that, "[b]ased on the administrative law judge's thorough review of the pertinent evidence . . . the Commission's conclusion as to the licensing issue is supported by substantial evidence." *Id*. PPC recently petitioned the Supreme Court to review the ITC and Federal Circuit decisions on the domestic-industry issue.

Later in 2011, the ITC rejected another NPE's domestic-industry argument and further clarified the domestic-industry requirement as it relates to licensing. In *Certain Multimedia Display & Navigation Devices & Systems, Components Thereof, & Products Containing Same*, Inv. No. 337-TA-694, Comm'n Op. (Aug. 8, 2011), the complainant, Pioneer, asserted infringement of two patents related to navigation systems and attempted to show a domestic industry based on its licensing activities. The ITC held that Pioneer did not satisfy the economic prong and set forth detailed factors for consideration of the issue in future cases. First, the ITC held that a complainant seeking to rely on licensing activities must satisfy three requirements: The investment must relate to the exploitation of the asserted patent, the investment must relate to licensing, and the investment must occur in the United States. *Id*.at 7–8.

Under the first requirement, the ITC held that a complainant must show a nexus between the licensing activity and the asserted patent. When the asserted patent is part of a patent portfolio, and the licensing activities relate to the portfolio as a whole, the courts must determine the strength of the nexus between the asserted patent and the licensing activities. On this issue, the ITC provided a non-exhaustive list of factors to consider, such as whether the licensee's efforts relate to an article covered by the asserted patent; the number of patents in the portfolio; the relative value contributed by the asserted patent to the portfolio; the prominence of the asserted patent in licensing discussions, negotiations, and any resulting licensing agreement; and the scope of technology covered by the portfolio compared to the scope of the asserted patent. *Id*.at 9. The ITC explained that the asserted patent may be shown to be particularly important or valuable within the portfolio where there is evidence that it was discussed during licensing negotiations, it has been successfully litigated before by the complainant, it is related to a technology industry standard, it is a base patent or pioneering patent, it is infringed or practiced in the United States, or the market recognizes the patent's value in some other way. *Id*. at 10–11.

Under the second requirement, the ITC held that the activities relied on must have a sufficient nexus to licensing as opposed to other activities, per the Federal Circuit's analysis in *Coaxial Cable*. Thus, for example, to rely on litigation expenditures, a complainant's efforts to license a potential infringer should be ongoing, and settlement discussions should be conducted throughout the litigation process.

As for the third requirement, the ITC held that showing a sufficient nexus to the United States is a case-specific inquiry into the extent to which a complainant conducts its licensing operations in the United States. In particular, ALJs should consider the extent to which the complainant employs domestic personnel or utilizes domestic resources. This makes sense, given that an original purpose of the statute was to protect entities with domestic operations that may be harmed by the importation of infringing articles.

Further, the ITC held that "[o]nly after determining the extent to which the complainant's investments fall within [the three] statutory parameters can we evaluate whether complainant's qualifying investments are 'substantial,' as required by the statute." *Id*. at 8. On this issue, the ITC provided several factors in determining substantiality. These include whether the complainant has exploited the asserted patents through activities such as research, development, or engineering; provides any compliance, training, or technical support for its licensees; is continuing its licensing activities; and has licensing activities that are consistent with those that are referenced favorably in the legislative history of the 1988 amendments to Section 337. *Id*.

Turning to the case at hand, the ITC held that Pioneer's investment was not substantial because its in-house licensing activity did not have a sufficient nexus to the asserted patents. In particular, the ITC held that Pioneer's licensing efforts were directed to its entire navigation portfolio, rather than the asserted patents, and that there was little evidence that Pioneer's licensing efforts related to an exploitation of the asserted patents. (The ITC's opinion in *Navigation Devices* was recently applied to deny relief to another NPE in *Certain Integrated Circuits, Chipsets, and Products Containing Same Including Televisions,* Inv. No. 337-TA-786, Order No. 19 (Fed. 15, 2012).) Further, the ITC gave little weight to Pioneer's expenditures on outside counsel, in part because such expenditures were related to litigation. More notably, the ITC also gave reduced weight to Pioneer's overall licensing activities because they were revenue-driven and not the "industry-creating, production-driven licensing activity that Congress meant to encourage." Thus, the ITC signaled its disfavor toward the purely revenue-driven licensing programs employed by many NPEs today, without outright rejecting the notion that such programs may be sufficient to satisfy the domestic-industry requirement in other cases with different facts.

The Outlook for the Future

Recent decisions appear to have raised the bar for NPEs to prove domestic industry through their licensing activities. Far from having a low threshold to show domestic industry, the decisions in *Coaxial Cable* and *Navigation Devices* set forth seemingly rigid requirements that many NPEs—particularly those involved in purchasing patents and asserting them for purely revenue-driven reasons—may find difficult to satisfy.

Moreover, there is reason to believe that the ITC will likely maintain the increased level of domestic-industry scrutiny for the foreseeable future. First, as previously stated, legislative history relating to the 1988 amendments suggests that Congress intended to limit the coverage of Section 337 to NPEs that actively innovate or license their rights to others for domestic production or employment. In this regard, the increased domestic-industry scrutiny set forth in recent decisions appears to be in line with the congressional intent relating to the very amendments that allowed NPEs to litigate in the ITC. Second, the increased scrutiny will likely diminish the recent explosion of ITC complaints being filed by NPEs, particularly those with little or no connection to employment or production in the United States.

NPEs now need to think long and hard about whether they are willing to spend the resources to file an ITC complaint because there is an increased possibility that the ITC will deny the relief they seek for failure to meet the domestic-industry requirement.

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