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# A preemptive power to offensive patent litigation strategy: Value creation, transaction costs and organizational slack<sup>☆</sup>

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## ABSTRACT

Offensive patent litigation is an increasingly important part of the firm's corporate strategy to protect the values of its intellectual property rights. Building on the value creation and transaction costs perspectives, this study explores how the preemptive power is most important to a firm's offensive patent litigation strategy through two key mechanisms. By applying an experimental design method to develop scenarios for top executives of publicly-traded companies and small- and medium-sized enterprises, the results show that both the patents' value creation based on their transaction costs and market positions influence the propensity of preemptive power separately through perceived benefits and organizational slack, and accordingly affect the offensive patent litigation strategy. These findings not only broaden the resource-based, transaction cost and value creation explanations of offensive patent litigation decisions, but also facilitate the formulation of the codes of conduct for the managerial capability in the contexts of offensive patent litigation.

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## 1. Introduction

Offensive patent litigation is an increasingly important part of the firm's corporate strategy to protect the values of its intellectual property rights (Chen, Ni, Liu, & Teng, 2015). While constituting a major dimension of how much value a patent owner can create and appropriate from the patent (Foss & Foss, 2005; Grimpe & Hussinger, 2014), offensive patent litigation can serve to leverage opportunistic licensing deals or advantageous settlement conditions through the patent enforcement mechanism (Guellec, Martinez, & Zuniga, 2012). In the context of offensive patent litigation, the existing literature focuses on the characteristics of patent litigation (Lanjouw & Schankerman, 2001), firm reputation (Agarwal, Ganco, & Ziedonis, 2009), preemptive power (Grimpe & Hussinger, 2014), and lawsuit-filing decisions (Somaya, 2003).

While the prevailing business environment may also have a deterrent effect of a tough patent enforcement reputation in rival firm behavior (Agarwal et al., 2009), the preemptive power of a patent portfolio is a

significant value determinant to offensive patent litigation (Grimpe & Hussinger, 2014). Thus, offensive patent litigation based on preemptive patenting strategy can be an important instrument in ensuring market exclusion, securing freedom to operate in R&D, and creating or appropriating the value from patented innovations. However, under which conditions the preemptive power is most important to a firm's offensive patent litigation strategy remains unclear.

A patent confers a right, not an obligation, to sue others for alleged infringement (Lanjouw & Schankerman, 2001), but offensive patent litigation entails substantial direct and indirect costs. The direct costs of enforcing patents include the costs of filing suits, attorney fees, and fees for examining the scope of patents. The American Intellectual Property Law Association (AIPLA)'s (2013) estimate of direct litigation costs for a patent dispute of average complexity can run in the range of between \$3 and \$5 million for each side through trial. As for the indirect costs, offensive patent litigation involves considerable organizational dislocation, absorbing the time and energy of key managers, lawyers, engineers and scientists in the company. In addition, Bhagat, Brickley, and Coles (1994), and Lerner (1995) find that the filing of the patent suits leads to a 2–3.1% average decrease in the market value of the firms involved. Thus, both the direct and indirect costs, which form part of the transaction costs, of offensive patent litigation indicate the costliness of the patent enforcement regime while a patent owner creates and appropriates value from the intellectual property rights. Understanding how managers make such trade-offs between value creation and transaction costs about their patents is of central interest in this study.

Most of the transaction costs studies examine the conditions of an exchange rather than those of value creation. For example, Coase (1988)

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identifies multiple sources of transaction costs, such as those of identifying a potential supplier, and the negotiating, drafting and monitoring of a contract, in an exchange. In turn, recognizing transaction costs—the costs of exchanging, protecting, and capturing intellectual property rights—is important to a firm's strategy, and Foss and Foss (2005) establish the linkage between transaction costs and value creation in that transaction costs influence the value that a resource owner can create. By applying the conceptualization of Foss and Foss (2005) to a patent litigation context, this study examines the conditions under which patent owners choose to initiate a patent enforcement regime in favor of value creation. The potential for hold-ups and opportunistic behavior regarding the preemptive power, which this study suggests, is the main determinant of an offensive patent litigation strategy.

This study has three contributions. First, the research builds on three theoretical foundations: value creation and transaction costs theory, and the resource-based view of the firm. While the resource-based perspective highlights the importance of organizational slack to the establishment of a patent portfolio and strategic decision making (Chen, Yang, & Lin, 2013), the transaction costs theory hinders the patent owner in realizing and creating the full potential value of the patents. Second, this study explores how the preemptive power is most important to a firm's offensive patent litigation strategy through two key mechanisms. From the resource-based perspective, the first mechanism looks at how the market positions drive organizational slack, and then affect the preemptive power. The second mechanism building on value creation and transaction costs theory considers how value creation based on transaction costs drives perceived benefits, and then determines the preemptive power. Third, by applying an experimental design method to develop scenarios for top executives of publicly-traded companies and small- and medium-sized enterprises, this study advances and enriches Chen et al.'s (2015) formulation of managers' codes of conduct in the contexts of offensive patent litigation.

## 2. Conceptual development and research hypotheses

The extant literature holds that the strategic use of intellectual property assets enhances a firm's competitive advantage, and implies that a firm enhances its ability to create value from its patents through a patent enforcement regime without considering the costs incurred by patent protection (Reitzig & Puranam, 2009). Arguably, such an emphasis implies that the absent transaction costs of protecting patents through offensive patent litigation is the setting underlying the Coase theorem, which states that firms can create all value from the exchange and use of an economy's available goods when transaction costs are absent (Foss & Foss, 2005). However, initiating a patent protection regime needs some transaction costs. In fact, the cost of enforcing patents, which forms part of the transaction costs, is several orders of magnitude larger than the cost of acquiring them (Agarwal et al., 2009). Thus, building on the value creation and transaction costs perspectives, this study argues that a firm will therefore choose to protect its intellectual property rights if the benefits from claiming them outweigh the transaction costs of an offensive patent litigation.

### 2.1. The propensity of preemptive power and offensive patent litigation

While scholars of economics, sociology and strategy focus on the positive reputation and high status of the firm, which can yield a premium and continued excellence (Roberts & Dowling, 2002; Shamsie, 2003), the existing literature on industrial economics highlights the strategic advantages of the firms, particularly in the context of entry deterrence (Kreps & Wilson, 1982; Milgrom & Roberts, 1982). In addition, as legal scholars note, determining whether changes to and 'designs-around' infringe a patented device in the absence of the filing of an offensive patent litigation is a difficult task (Moore, Holbrook, & Murphy, 2013).

From market-entry deterrence perspectives, the firm has an advantage over its rival by virtue of its ownership of patents related to the innovation, which is analogous to a cost advantage (Scherer, 1980). Even if the costs of being litigious in a particular patent lawsuit outweigh the benefits, the deterrence of future knowledge spillovers can justify the investment (Agarwal et al., 2009). Thus, in line with the strategic deterrence literature, preemptive power can shape others' perceptions of patent litigiousness. Accordingly, this study makes the following prediction:

**Hypothesis 1.** The propensity of preemptive power positively influences the companies' offensive patent litigation strategy.

### 2.2. Perceived benefits and the propensity of preemptive power

The strategic management, law and economics literature suggests that the perceived benefit associated with patent litigation can differentially affect the behavior of the firms (Lanjouw & Lerner, 2001; Lanjouw & Schankerman, 2001; Somaya, 2003). By engaging in costly patent lawsuits, firms can build a reputation for toughness in entry deterrence to shape the expectations of third parties (Agarwal et al., 2009). Thus, the patent litigant can credibly commit by investing in building a reputation for toughness—even if the cost of doing so in a particular patent litigation exceeds benefit in that instance—since the expected benefit from such a reputation includes inhibiting competition by deterring other firms' entry (Kreps & Wilson, 1982; Milgrom & Roberts, 1982). Although the winning probability of a patent litigation is uncertain (Somaya, 2003), previous studies (e.g., Becker & Brownson, 1964) show that the perceived outcome positively influences decision makers to accept an option even under an uncertain environment. Accordingly, this study makes the following prediction:

**Hypothesis 2.** In the context of offensive patent litigation, a company's perceived benefits positively influence its propensity of preemptive power.

### 2.3. Value creation based on transactions costs and perceived benefits

A patent is valuable over and above the value of the technological knowledge since it constitutes a property right that restricts a competitor's ability to imitate and protects the resource from value erosion (Chen et al., 2015; Grimpe & Hussinger, 2014). The previous literature indicates that the value creation of a patent has solid theoretical foundations based on the economics of property rights (Barzel, 1997; Coase, 1988), and implies that transactions costs influence the value that a patent owner can create (Foss & Foss, 2005). In addition, Agarwal et al.'s (2009) findings contribute new evidence to a handful of studies (Lanjouw & Lerner, 2001; Lanjouw & Schankerman, 2001) by exploring how the high costs of patent enforcement may tilt the advantage toward firms with superior resource endowments.

Somaya (2003) demonstrates that the benefit associated with a litigated patent positively influences decision makers' active patent decisions in which the patentee's strategic stake has a pronounced and robust positive effect on the probability that the suit will go to a court decision. Thus, this study would like to explore whether the variation in value creation based on transactions costs affects the firm's perceived benefit to litigate to protect its patents.

**Hypothesis 3.** In the context of offensive patent litigation, the patents' value creation based on transaction costs positively influences the company's perceived benefits.

### 2.4. Market positions and organizational slack

In the context of reactive patent litigation, Chen et al. (2015) find that a firm's market positions, leader vs. follower, are crucial to a firm's

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