



**Committee on the Judiciary
United States Senate
Hearing
“S. 1137, the ‘PATENT ACT’ – Finding Effective
Solutions to Address Abusive Patent Practices”**

Prepared Statement of
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Mr. Chairman, Senator Leahy, and distinguished members of this Committee, thank you for the opportunity to testify on the plague of abusive patent litigation and on the recently introduced PATENT Act, which would make great progress towards a cure. I am Senior Vice President and General Counsel of Cisco Systems, where my responsibilities include both intellectual property and litigation. We own over 12,000 issued US patents and have one of the top ranked portfolios in our industry. We employ over 36,000 people in the United States and spend over \$6 billion annually on research and development. I am here on Cisco’s behalf, but the problems I am describing affect not only my industry but also start-ups, restaurants, hotels, retailers, realtors, and auto manufacturers. That’s why we have formed a very broad coalition called United for Patent Reform to press for needed change.

In recent years, I have testified several times in both chambers about how our great nation’s patent system has been hijacked by scam artists and profiteers. I have spoken about the imperative for strong, focused legislation that will return the patent system to its original purpose of encouraging innovation. Today, I am back again on Capitol Hill because my company, my customers, and American businesses large and small are still suffering from meritless patent suits. Change is more urgently needed than ever. But I also hope the introduction of the PATENT Act, and

the parallel consideration of the Innovation Act in the House, are the first strong steps toward the rapid enactment of a new law that will take back our patent system from its abusers.

When I last testified on this subject in 2013, I pointed out that I was forced to spend more than \$50 million on patent litigation annually, money I had to take away from new patent filings.¹ In fact, in the last five years I have been forced to waste more than a quarter of a billion dollars on patent litigation. Today, I have more than 50 patent litigations where Cisco or a customer is a defendant, virtually all of which are from patent assertion entities (PAEs) whose only real business is litigation.

One particular case from our recent past will show you why this problem is so much bigger than Cisco or the tech industry. A lawyer named Noel Whitley bought patents related to Wi-Fi from his former employer Broadcom and then worked with the Niro firm, which specializes in helping patent assertion entities target legitimate businesses. He set up a company called Innovatio, which despite its name has absolutely nothing to do with innovation. The patents were near their expiration date, heavily licensed to Broadcom's competitors and customers, and subject to binding commitments to license on reasonable terms.

Whitley and the Niro firm sent over 14,000 letters to small businesses including cafes, bakeries, motels, even a children's health clinic—anyone who he

¹ *Abusive Patent Litigation: The Impact on American Innovation & Jobs, and Potential Solutions; Hearing before the House Judiciary Committee (Mar. 14, 2013) (statement of Mark Chandler)* at 3, available at http://judiciary.house.gov/files/hearings/113th/03142013_2/Chandler%2003142013.pdf (last visited May 5, 2015).

thought might use the ubiquitous Wi-Fi standard. He told these small businesses that his patent portfolio covered all the WiFi access points they were using. He didn't tell them about the huge number of WiFi devices that were already licensed because of Broadcom's cross-licenses and the license Broadcom kept for itself. Instead he demanded \$3000 per location, for patents now determined in court to be worth pennies per chip. He didn't tell the businesses that Cisco had sued Innovatio to protect its customers, but rather misrepresented to them that equipment manufacturers "have not stepped in to defend any of their users."

Whitley and the Niro firm had planned to extract \$4 billion from the productive part of the American economy but in the end, this scam was shut down. We, with Netgear and Motorola, litigated aggressively, and Innovatio was forced to take less than 3.2 cents per chip. We got the right result, but unfortunately, we had to pay \$13 million in legal fees to get there.

In another example, a publicly traded PAE called VirnetX approached us, at first ostensibly to convince our engineers to adopt their so-called "security" technology to include in our products. They made no mention of patent infringement. But after we told them that we did not want to redesign our products to include their technology, they sued us for patent infringement and accused us of *already* using their technology. The earlier approach was later used as the basis to accuse us of willful patent infringement and further inflate their astronomical demands, even though they had made no mention earlier of any existing Cisco usage of their technology. As the litigation progressed, they made misleading statements

to the investor community to boost their stock price. They forced us to spend \$1.5 million on the pointless production of the electronic equivalent of over 1000 banker's boxes of largely irrelevant documents. Ultimately, we prevailed at trial.

Unfortunately for us however, we had to spend \$20 million in legal fees to obtain this result, money unavailable for actual innovation at Cisco. Even worse, senior technical talent at our company took time away from inventing. It is incredibly frustrating to me to see our most valuable engineers being forced to stop inventing and innovating to make time to educate our lawyers and attend depositions and trials for cases that never should have been brought but for unwarranted leverage of the litigation system and the risks and costs it imposes. Moreover, key VirnetX patents are now being reexamined by the PTO, which has determined that there is a reasonable probability that one or more claims will prove invalid.

But the gamesmanship and abuse of our VirnetX and Innovatio cases are unexceptional. They are business as usual in an American patent litigation system in desperate need of reform. Between 2005 and 2014 there was a nearly **3-fold** increase in NPE litigation in the United States, as measured by the number of defendants.² In the first quarter of 2015, NPEs accounted for 62% of all new patent cases and 84% in the IT industry, versus about 20% ten years ago.³ Although we are blessed with many innovative industries in our country, no one can realistically

² *2014 NPE Litigation: New and Smaller Targets*, RPX Corporation (January 9, 2015), <http://www.rpxcorp.com/2015/01/09/2014-npe-litigation-new-and-smaller-targets-2/> (last visited May 5, 2015).

³ *Q1 2015 Patent Dispute Report*, UnifiedPatents (April 8, 2015), <http://unifiedpatents.com/q1-2015-patent-dispute-report/> (last visited May 5, 2015).

claim that this massive increase in NPE litigation is in any way proportionate to a similar increase in the level of innovation.

Now for a special note about statistics and people who misuse them to claim that our problem is non-existent, exaggerated, or diminishing. Last year the level of patent litigation decreased somewhat from the previous year and the defenders of the current broken system hastily seized on this blip to claim that reform was unwarranted. They conveniently ignored that the longer term trend was one of explosive growth. In any event, that trend has unfortunately resumed. In the first quarter of 2015, NPE litigation increased 42% over the previous quarter.⁴ We need patent litigation reform more than ever.

Behind the dry statistics though are the real stories of abuse like the Innovatio and VirnetX cases. The PAEs study their targets and adjust their scams accordingly. When I last testified, I talked about the game of shaking down numerous small end users with deceptive demands that we successfully fought in our Innovatio case. A survey of venture capitalists and their portfolio companies illustrates how NPEs crush fragile startups with expensive litigation and extortionate demands.⁵ Every one of the more than 200 venture capitalists surveyed stated that they might refrain from investing in a company that had received a patent demand, and more than half of the VCs stated that it would be a

⁴ *Q1 2015 Patent Dispute Report*, UnifiedPatents (April 8, 2015), <http://unifiedpatents.com/q1-2015-patent-dispute-report/> (last visited May 5, 2015).

⁵ Robin Feldman, *Patent Demands & Startup Companies: The View from the Venture Capital Community*, UC Hastings Research Paper No. 75 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2346338 (last visited May 5, 2015); see also Colleen Chien, *Startups and Patent Trolls*, Stan. Tech. L. Rev. (forthcoming Sept. 28, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2146251 (last visited May 5, 2015).

major deterrent. Approximately, three-quarters of the VCs reported that reported that patent demands had a significant impact on the companies that received them by distracting employees, consuming scarce resources, and altering business plans. Overall, 92% of the VCs reported that patent demands are a problem for venture-backed companies.

One important part of fixing the patent system is, of course, fixing patent quality. We applaud the leadership of Director Michelle Lee and the USPTO in making examination quality a top priority and we look forward to continued strides. The new post-grant proceedings created by the America Invents Act have been highly successful in efficiently weeding out bad patents that should never have been granted. We should find a way to stop hedge funds from filing spurious review requests to manipulate the stock price of innovative life sciences companies. This practice outrages me. But we must preserve the post-grant proceedings as an openly accessible tool for protecting the public from improperly granted patents.

But patent quality is only part of the story. An astounding 40% of the suits last year were filed in only two judicial districts where less than 1.5% of Americans live. When plaintiffs and defendants pervasively believe, rightly or wrongly, that judicial results depend on where an action is brought, fundamental precepts of legal integrity and the rule of law are endangered. PAEs are attracted to a game where they have much to gain and little to lose. They can hide ownership with shell entities. They can threaten small businesses with letters that hide and misrepresent key information about their assertions. They can file suit based on unsupported and

unexplained allegations. They ask for and get vast productions of documents in discovery but only in order to drive up costs rather than to ferret out relevant facts. If they win at the end, they stand to make a killing even in cases where logic would say damages should be small, since damages in patent cases are hard to predict. If they lose, the defendant nonetheless is out millions of dollars for defense. The pressure is to settle, but not based on the quality and relevance of a patent, rather only on the unfair and asymmetric rules of the game.

Fixing this problem requires congressional action. We need a uniform and fair system for patent litigation in addition to transparency in ownership and effective limitations on deceptive patent demand letters. The courts cannot solve this problem on their own. The graph in Appendix A shows how patent litigation has continued to grow in tandem with helpful Supreme Court and CAFC decisions. Each decision was decried as a blow against the patent system on the one hand but also as the silver bullet against our PAE complaints. Ironically, those who point to these decisions as the solution to our complaints are the very ones who vigorously advocated against them. For example, consider the Supreme Court fee shifting decision in *Octane*. Early data indeed shows an uptick in fee shifting awards, but it is unevenly distributed among districts.⁶ Fee shifting is still not happening enough to serve as a deterrent, but that is no wonder given that the decision simply changes how to interpret the statutory term “exceptional” when the bad conduct is in fact commonplace.

⁶ Federal Circuit Bar Association, *A Comparison of pre-Octane and post-Octane District Court Decisions on Motions for Attorneys’ Fees Under Section 285* (2015), available at <http://ipwatchdog.com/materials/FCBA-Fee-Shifting-Paper.pdf> (last visited May 5, 2015).

Fortunately, through the leadership of Chairman Grassley, Ranking Member Leahy, Majority Whip Cornyn, and Senators Schumer, Hatch, Klobuchar, and Lee, help is on the way. The newly introduced PATENT Act is a good start with many positive features that I will now explain along with a few suggestions for improvement. We also applaud the reintroduction of the House Innovation Act by Chairman Goodlatte and nineteen cosponsors of both parties.

First, I want to praise the PATENT Act for addressing patent quality. The bill makes some technical fixes to the AIA including correcting a scrivener's error that gave the post-grant review proceeding the wrong estoppel standard. It also beneficially provides some incentives for transparency and sunlight about patent ownership. But I'm going to focus on a set of provisions that quite comprehensively address and try to break the underlying business model of frivolous patent assertion.

Abusive and deceptive demand letters are a scourge to small businesses. The Innovatio case is one example and I have testified about others in the past.⁷ Many states have now passed laws to directly address this kind of abuse. The PATENT Act helpfully includes language that will discourage this kind of deception both by denying claims of willful infringement based on deceptive communications and by clarifying that bad-faith demand letters are a legitimate object of FTC enforcement. The PATENT Act, unlike the TROL Act which we and our coalition oppose, leaves

⁷ *Trolling for a Solution: Ending Abusive Patent Demand Letters (April 8, 2014)* (statement of Mark Chandler) at 4-11, available at <http://docs.house.gov/meetings/IF/IF17/20140408/102105/HHRG-113-IF17-Wstate-ChandlerM-20140408.pdf> (last visited May 5, 2015).

states free to adopt their own laws to address this fraudulent behavior. I would welcome further improvements to the PATENT Act's language including removing the difficult to parse requirement that the sending of deceptive communications be "widespread" for the FTC provision to apply.

Under current law, PAEs can start an expensive lawsuit with a vague complaint that doesn't explain the basis of infringement or identify the real interests behind the lawsuit. The defendant has to start spending money even though the plaintiff may only be on a fishing expedition having done none of the needed homework upfront. The PATENT Act forces the plaintiff to include basic information about what patent claims are being infringed, by which products, and how. The PATENT Act also helpfully requires early disclosure of the financial interests behind the lawsuit and any licensing commitments that have been made to standards bodies. The pleading and disclosure provisions would be a big improvement to current law. To ensure that the intent is carried out uniformly across the country, I recommend that the language requiring that the basis for infringement be explained "with detailed specificity" and "where each element . . . is found" be imported from the Innovation Act.

Another favorite abusive tactic is to sue the users and customers of technology rather than the vendors. Sometimes, the abusers reason that they are better off picking off customers whether they be large retailers or small independent coffee shops that know their own business but of course have little reason to understand the innards of WiFi technology or even have access to

sophisticated patent counsel. In other situations, PAEs opportunistically pick the users of technologies whether they be internet service providers or retailers to get a chance at winning a royalty based on their total revenue rather than the much smaller value of the equipment that actually includes the accused infringing technology. The PATENT Act greatly strengthens the ability for vendors like my company to step in and have the suits of our customers stayed while we litigate the real issues. Although I would be able to suggest improvements to the language, I appreciate that it represents a painstaking compromise that is acceptable to a range of interests and I support it.

The PATENT Act also addresses the problem of excessive and unnecessary discovery that raises costs. One unfortunate omission however is the limited stay of discovery prior to claim construction (the so-called Markman ruling) that is included in the Innovation Act. The Markman ruling significantly narrows the issues under dispute and clarifies the meaning of the patent to set the stage for further analysis of infringement and validity. The Innovation Act's pre-Markman stay of discovery would significantly reduce the early stage cost of litigation, reducing the pressure for shakedown settlements unrelated to the merits. I understand that some stakeholders who practice their inventions are concerned that business-critical litigation against competitors would be unnecessarily delayed. However, the Innovation Act specifically carves out competitor litigation from this provision, an approach that could be matched in the Senate. We would be open to further changes to protect the important pre-Markman discovery requirements in certain types of litigation.

Fortunately, the PATENT Act does instead include another very useful provision for reducing unnecessary discovery early in the case by staying discovery pending venue transfer motions, motions to sever, and motions to dismiss. It makes no sense to waste money on discovery when a case may be on the cusp of being dismissed or transferred to another venue with different procedures. I hope that this also brings the important benefit of accelerating transfer motion decisions to occur before the parties and the court waste time and money litigating in the wrong venue.

There are two important improvements that are needed to make this provision fully effective. First, transfer motion decisions should be subject to interlocutory appeal so that this important area of law is applied uniformly to limit forum selection gamesmanship. Second, by explicitly allowing courts to require the exchange of validity and infringement contentions, the provision, I think unintentionally, opens a loophole that would potentially exempt these important issues from the discovery stay and effectively allow most discovery to continue anyway. Given the speed with which these early dispositive motions should be decided, allowing the exchange of contentions is unnecessary. So I recommend either clarifying that such early contentions would be preliminary and thus not require discovery or eliminating the reference to exchanging contentions entirely.

Excessive discovery drives litigation costs at later stages as well. There have been improvements in local discovery rules but they have so far been inadequate.⁸ The excessive costs of the discovery system are not just a matter of local court procedure but have national economic consequences because of how they force innovative companies to choose between paying for document production or paying off the owners of weak patents. It is appropriate for Congress to act to rein in the abuses. I have long supported cost shifting for discovery beyond the core of a patent case. The PATENT Act encourages the Judicial Conference to define core discovery and make rules for cost shifting. However, given the criticality of the issue, I recommend that Congress take a more prescriptive approach by directly mandating cost shifting beyond whatever core the Judicial Conference defines.

I welcome the fee shifting provision of the PATENT Act. It is essential to deter abusive patent litigation with a meaningful penalty. It targets unreasonable behavior and litigation positions but does not distinguish among different kinds of entities or between plaintiffs and defendants. It will be far more effective than the *Octane* decision in making bad patent litigation behavior risky. For reasons of national uniformity, I prefer the presumptive language used in the Innovation Act.

Making sure that fee shifting works in practice also requires making sure the backers of judgment-proof shell plaintiffs are left on the hook. There is seemingly

⁸ For example, the new Model Order Regarding E-Discovery in Patent Cases in the Eastern District of Texas limits the number of electronic custodians and the number of search terms per custodian, but still allow very general search terms (e.g., “WiFi”) to be applied to vast repositories. See Model Order Regarding E-Discovery in Patent Cases (E.D. Tex. March 19, 2014), available at http://www.txed.uscourts.gov/cgi-bin/view_document.cgi?document=22218 (last visited May 5, 2015).

no limit to the creativity of the masterminds of patent profiteering in creating convoluted public and private ownership structures. I appreciate Senator Hatch's leadership and the contributions made by his colleagues to creating a fee recovery provision that will hold the profiteers accountable while not creating unnecessary obstacles to bringing patent cases to court. This provision also reflects the give and take necessary to arrive at a result acceptable to diverse interests.

Finally I want to praise the PATENT Act for what it does not do. The drafters have wisely resisted the temptation to balance needed improvements in patent litigation with more harmful attempts to weaken changes enacted as part of the AIA. Unlike the Innovation Act and the STRONG Act, the PATENT Act leaves the USPTO's longstanding rules for claim interpretation in post-grant proceedings undisturbed. It is important that the final legislation follows this approach. The USPTO must be able to apply prior art that is relevant under the broadest reasonable interpretation (BRI) of the patent to assure that any resulting confirmed patent is entitled to its presumption of validity in every courtroom that takes its own differing approach.

I would also point out that in addition to the BRI issue, provisions from the STRONG Act would further damage the patent quality gains of the AIA. In an ostensible effort to address the outrageous shenanigans of hedge funds who file IPRs while shorting their owners' stocks, the STRONG Act restricts usage of the post-grant proceeding to litigants and other specifically threatened parties. The problem of abusive hedge fund IPRs, although still nascent, should be solved but it should be solved with appropriate targeted securities law changes. The post-grant

proceedings should remain open to the broader public excepting of course the owners and inventors of challenged patents. A weak patent imposes costs and uncertainties on many parties, not just litigants and would-be litigants.

Consortiums and public interest organizations should continue to be able to aggregate resources to kill bad patents for the public good.

Mr. Chairman and Distinguished Members of this Committee, you now have a real opportunity in front of you to change the rules and make patent profiteering unprofitable. The PATENT Act, as introduced, is a good start. We and our allies will be behind you as you move forward to evolve and strengthen it over the coming weeks and hopefully enact it into law. Thank you.