

Hearing on H.R. 1260, the “Patent Reform Act of 2009”

House Committee on the Judiciary

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Testimony of David Simon

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Mr. Chairman, Ranking Member Smith, and members of the Committee. My name is David Simon and I am Chief Patent Counsel for Intel Corporation. Thank you for the opportunity to appear before you today to address the very important topics of patent law reform in general and H.R. 1260 in particular. We appreciate your tireless efforts on behalf of patent reform, stretching over three Congresses, and thank you for introducing H.R. 1260 this year. We strongly support its enactment.

From our founding by Gordon Moore of Moore’s law fame, Intel has focused on innovation. Intel over the last few years has invested about five billion dollars annually on R&D. We are investing over seven billion dollars in our factories here to build our latest generation of products that are smaller than a thumb nail and contain over one billion transistors. And to protect that investment and products, we have obtained over 9000 US patents since 2004.

As one of America’s leading innovators, Intel recognizes the critical importance of a strong and effective patent system that protects actual inventions and thereby provides an essential incentive for inventors. Unfortunately, our patent system today is failing to perform this key function. Too often, the patent law—and especially patent litigation, or the threat of litigation—is being used to

extract unjustified payments from true innovators, and thus is deterring rather than promoting real innovation. Patent law today provides an economic *disincentive* to innovation in the technology industries, precisely the opposite of what it is supposed to do.

I will focus my testimony on the aspects of H.R. 1260 that relate to patent litigation rules, because reform in that area is essential in order to correct the current imbalance in patent law. Nothing less than America's technological leadership is at stake.

The patent litigation rules that govern today's lawsuits were adopted in a very different era, when claims virtually always were asserted by one product manufacturer against the manufacturer of a competing product, alleging that the defendant's product infringed the plaintiff's patent and was diverting customers from the plaintiff to the defendant. The principal measure of damages sought was the profits lost by the plaintiff due to the diversion of sales to the defendant.

Although that type of patent litigation may remain the norm in some sectors of the economy, it most definitely is not in the technology industries. The last ten years have seen a fundamental change in the litigation environment for technology companies, with the overwhelming majority of royalty demands, whether pre-litigation or in court, now asserted by non-practicing entities ("NPEs")—businesses that do not manufacture or sell products and that do not conduct research and development. As explained in a recent report on the patent system issued by the Center for American Progress,

[u]nlike operating companies that produce products and services, and universities that generate most of their revenue from tuition and grants and generate intellectual property through academic investigations, patent-holding entities typically do not produce any products or offer any service beyond patent licensing and enforcement. Their primary revenue sources are royalties obtained

from asserting patents against successful product and service companies.¹

NPEs have targeted their patent claims against technology companies. Press reports indicate that a handful of NPEs have raised \$3.5 billion and are seeking more funds;² these multi-billion dollar resources have been used for the acquisition of thousands of patents in the technology area. Indeed, one study found that 24 NPEs hold more than 16,000 patents, virtually all in the technology area.³

It therefore is not surprising that a survey of leading technology firms revealed that NPEs were the source of **88%** of the patent claims asserted against those companies.⁴ And the number of claims has skyrocketed in the last four years, with royalty requests up 650% and lawsuits nearly doubling.⁵

Why have NPEs targeted technology patents?

The answer is simple: because the presence of hundreds, if not thousands, of components technology-related products and the tendency toward standardization that allows technology products to interact—as well as the widespread use of technology by companies throughout the economy—allows NPEs to assert claims against multiple defendants based on alleged infringement of the same patent. That increases exponentially the potential “return” on each patent purchased by the NPE and each claim and lawsuit in which the NPE “invests.”

¹ <http://www.scienceprogress.org/2009/01/tackling-the-challenge-of-patent-reform/>.

² Patent Pirates,” http://www.forbes.com/free_forbes/2007/0507/044.html; “Tech Guru Riles the Industry By Seeking Huge Patent Fees,” Wall Street Journal (Sept. 17, 2008); <http://richard-wilson.blogspot.com/2008/02/litigation-funding-from-hedge-funds.html>.

³ <https://www.patentfreedom.com/research-ph1.html>.

⁴ Testimony of Steven R. Appleton before the Senate Judiciary Committee at 4-5 (March 10, 2009).

⁵ *Id.*

A sample of press reports regarding cases filed just during the last four months provides vivid confirmation of the NPEs' strategy, none of which apparently represent lawsuits between competitors:

- *Odom v. Attachmate Corporation et al.*, a suit against 28 software companies alleging infringement of a patent relating to the manipulation of software tool groups;⁶
- *Aldav, LLC v. Clear Channel Communications et al.*, a suit against 13 large broadcasting companies alleging infringement of a patent relating to internet radio advertisements;⁷
- *Implicit Networks v. HTC Corp. et al.*, a suit against 6 large consumer electronic manufacturers relating to touch screen controls;⁸
- *Parallel Networks, Llc v. Amazon.Com, Inc. et al.*, in this and related suits the plaintiff and its predecessor in interest have sued dozens of retailers and on-line service providers alleging that their web sites infringe its patents;⁹
- *Actus, LLC v. Bank of America Corp. et al.*, a suit against 20 large companies that offer gift cards and online payment options alleging infringement of four patents relating to electronic payment systems;¹⁰
- *Zamora Radio LLC v. Last fm Ltd. et al.*, a suit against 11 companies that operate web sites that provide live streaming audio alleging infringement of a patent relating to Internet radio technology;¹¹
- *Acquis LLC v. Appro International Inc. et al.*, a suit against 10 computer manufacturers alleging infringement of several patents related to blade server technology;¹²
- *Information Protection and Authentication of Texas, LLC v. Symantec Corp. et al.*, a suit against 22 large software companies alleging infringement of the plaintiff's very general patents relating to security scanning.¹³
- *Clear With Computers LLC v. Bassett Furniture Industries Inc., et al.*, a lawsuit accusing 40 companies of violating two patents relating to computer-assisted sales (the same plaintiff subsequently filed another lawsuit against an additional 12 companies).¹⁴

⁶ See <http://www.law.com/jsp/iplawandbusiness/PubArticleIPLB.jsp?id=1202430120283>.

⁷ *Id.*

⁸ *Id.*

⁹ See <http://www.law.com/jsp/iplawandbusiness/PubArticleIPLB.jsp?id=1202429982289>.

¹⁰ See <http://ip.law360.com/articles/96455>.

¹¹ See <http://ip.law360.com/articles/96414>.

¹² See <http://ip.law360.com/articles/95338>.

¹³ See <http://ip.law360.com/articles/89883>.

¹⁴ See <http://ip.law360.com/articles/89471> & <http://ip.law360.com/articles/94040>.

- *DataTern Inc. v. United Air Lines Inc.*, a suit against 7 major travel and financial services companies alleging infringement of a patent relating to accessing databases (the plaintiff previously had sued “a large number of companies” in a prior action relating to the same patent);¹⁵
- *Finoc Design Consulting Oy v. 2Wire Inc. et al.*, a suit against 15 companies that provide devices or services relating to wireless broadband communications alleging infringement of its patent relating to broadband data transmission;¹⁶
- *IP Co. LLC v. Oncor Electric Delivery Co. LLC et al.*, a suit against 7 wireless companies alleging infringement of two patents relating to wireless technology;¹⁷
- *Card Activation Technologies Inc. v. Barneys New York Inc.*, in this and related cases the plaintiff has sued 14 major retailers alleging violation of its patent relating to gift card technology;¹⁸
- *SBJ IP Holdings 1 LLC v. Sears Brands LLC et al.*, a suit against 7 major retailers alleging violation of a patent relating to tracking consumer preferences over the Internet;¹⁹
- *Linksmart Wireless Technology LLC v. Six Continents Hotels Inc., et al.* in this and related cases the plaintiff has sued more than 25 companies, including hotel chains, Wi-Fi providers, and companies that provide wireless networks to their customers, alleging infringement of its patent relating to Wi-Fi technology;²⁰
- *DNT LLC v. Sprint Nextel Corp. et al.*, a suit against 6 wireless technology companies alleging that their modem cards infringe a patent relating to dialing technology.²¹

As these examples show, although technology companies are a consistent target, other companies that use technology are also targets of NPEs.²² Using my hobby of photography as an example, I found local photographers who maintain websites to sell their pictures that face at least three different NPEs who actively litigate against people who simply sell their own pictures on the web.

¹⁵ See <http://ip.law360.com/articles/87807>.

¹⁶ See <http://ip.law360.com/articles/86311>.

¹⁷ See <http://ip.law360.com/articles/85264>.

¹⁸ See <http://ip.law360.com/articles/84749>.

¹⁹ See <http://ip.law360.com/articles/84311>.

²⁰ See <http://ip.law360.com/articles/84101>.

²¹ See <http://ip.law360.com/articles/83084>.

²² For example, defendants in the cases listed above include major retailers, hotel companies, and other businesses.

This litigation effectively imposes a tax on the creation and use of innovative technology products. That is precisely the opposite of what we want in our economy?

Some opponents of reform respond that the litigation system will dispose of these cases appropriately—if the claim is meritless, it will be rejected and NPEs will be deterred from asserting similar unjustified claims. That view reflects a fundamental misunderstanding of the realities of patent litigation resulting from rules designed for the era of manufacturer vs. manufacturer litigation. The NPEs’ strategy exploits these realities very effectively to coerce settlements in even illegitimate cases.

First, patent infringement cases are very expensive to defend—the average costs are \$5 million *per defendant*²³ and taking a case to trial will consume three or four times that amount. I have spoken to defendants who can neither afford to litigate nor can afford to settle. Winning defendants do not recover their costs in our system, and there is accordingly a huge incentive to settle even unjustified claims in order to avoid these expenses.

Second, even a defendant that is confident that it did not infringe the plaintiff’s patent cannot be certain of winning at trial. The standards governing patent validity and infringement are general principles that must be applied by the factfinder, and lay juries—an increasing percentage of patent cases are decided by juries—often are reluctant to conclude that a patent granted by the experts at the PTO is invalid or that the plaintiff has failed to prove infringement.

Third, and most importantly, the damages standard that applies in cases brought by NPEs—the “reasonable royalty” test, which typically consists of instructing the jury on the 15 so-called “Georgia-Pacific” factors—is vague and uncertain, not at all up to the task of providing

²³ AIPLA Report of the Economic Survey 2007, at 25-26.

meaningful guidance to judges and juries. The comments of academic experts at a recent FTC roundtable on the subject are instructive. For example, Tom Cotter, Briggs and Morgan Professor of Law, University of Minnesota Law School, observed that the “Georgia-Pacific factors . . . can be so easily manipulated by the trier of fact to reach virtually any outcome.”²⁴

The flaws in the *Georgia-Pacific* test are especially pronounced when the plaintiff’s target is a complex product made up of many different components—the situation that is typical for technology products. For example, Intel reviewed one of its products several years ago and stopped counting when we determined that the product incorporated 1500 of our patents. Again, the academic experts have explained the problem:

- Professor John Thomas, Georgetown University Law Center: “[T]he case law and empirical evidence alike suggest that courts are inclined to award damages that far exceed an individual patent’s contribution to that particular product. . . . Damage awards that dramatically exceed the commercial value of the patented invention lead to a number of deleterious practical consequences.”²⁵
- Professor Mark Lemley, Stanford Law School: “Because courts have interpreted the reasonable royalty provision to require the award of royalties based on the ‘entire market value,’ juries tend to award royalty rates that don’t take into account all of the other, unpatented components of the defendant’s product. This in turn encourages patent owners in those component industries to seek and obtain damages or settlements that far exceed the actual contribution of the patent. There are numerous cases of just this problem occurring. . . . There seems to be consensus that reasonable royalty damages should be limited to the share of a product’s value that comes from the invention and that patentees should not be able to capture value they did not in fact contribute.”²⁶

²⁴ FTC Hearing on The Evolving IP Marketplace - Remedies (Feb. 11, 2009), Panel 1: Standards for Assessing Patent Damages and Their Implementation by Courts (Webcast available at <http://www.ftc.gov/bc/workshops/ipmarketplace/>).

²⁵ *Patent Reform Act of 2007*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 110th Cong., 1st Sess. 63 (2007).

²⁶ *Patent Quality Enhancement in the Information-Based Economy*: Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 109th Cong., 2d Sess. 38 (2006).

Indeed, the case law explicitly permits reasonable royalty awards that *exceed* the infringer's entire profit on the infringing product or service—making clear that the entire standard has no basis whatever in economic reality: such a royalty is by definition unreasonable, because a product manufacturer would stop making the product rather than pay it. But this legal rule authorizes NPEs to pursue irrational damages demands with impunity.

Even Philip S. Johnson of Johnson & Johnson has noted that the *Georgia-Pacific* test is not the best solution in all cases:

“[A] promising approach to this reasonable royalty problem, at least for circumstances involving non-practicing patentees with no competitive interests in the field, may be to focus on ascertaining the incremental value to the infringer, at the time just before the infringement began, of using the invention compared to not using it, or to using its closest reasonably available non-infringing substitute, and then determining the fair proportion of that value that should be paid to the patent owner for that use.”²⁷

This Committee's report on the Patent Reform Act of 2007 recognized the “numerous studies showing that current litigation practices often produce a royalty award substantially in excess of a reasonable royalty” and that “[t]his cycle is harmful to our overall economy and especially damaging to technology innovation.”²⁸ Recent studies have provided additional evidence confirming the correctness of the Committee's conclusion.

Professors Shapiro and Lemley have documented that median royalty rates in patent infringement cases based on a reasonable royalty theory average approximately 5.5%. Their comparison between jury verdicts regarding multiple component products versus those involving single component products shows that the reduction in royalty rate is equivalent to a conclusion that there are on

²⁷ Prepared Statement of Philip S. Johnson, Chief Intellectual Property Counsel, Johnson & Johnson, before the U.S. Senate Committee on the Judiciary 16 (March 10, 2009), *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=3701&wit_id=7661

²⁸ H.R. Rep. 110-314, at 26.

average less than 1.5 components in a multicomponent invention.²⁹ Obviously, this does not reflect commercial reality in many industries, and especially not in the technology industries where a company such as Intel may have thousands of its own patents in its products. The inevitable result is excessive royalty awards in multicomponent products such as those produced by technology companies.

Indeed, studies of damages awards in infringement cases have found that the median awards are *higher* in technology industries than in other industries—just the opposite of what would be expected. The greater number of patented components in technology products necessarily means that each component is less valuable; otherwise, the sum of the patent royalties would exceed the total value of the product. But the higher damages awards in the technology industries confirm that juries are actually assigning a higher value to the components than to an entire product in other industries.

Thus, PricewaterhouseCoopers' study of 2008 damages awards found that the median damages in telecommunications cases to be \$31 million, compared to a median of \$1.5 million in pharmaceutical cases, a difference of 2,000%.³⁰ Because a telecommunications product has many more separate components than a drug, this result confirms the excessiveness of technology damages determinations.

Professor Janicke has published data on recent jury verdicts that leads to a similar conclusion. When I compared the median damages awards in technology and non-technology cases decided in 2005-2008, the median was \$18.5 million for technology company cases, compared to \$3.74

²⁹Lemley & Shapiro, "Patent Holdup and Royalty Stacking," 85 Texas Law Review 1991, 2034 (2007).

³⁰<http://www.ftc.gov/bc/workshops/ipmarketplace/>.

million in other cases. This is a 500% difference that is precisely the opposite of what would be expected if juries were properly applying the reasonable royalty standard.³¹

Faced with millions of dollars in litigation costs and the risk of an unjustified excessive verdict, it is not surprising that defendants settle even unjustified infringement claims. That means that an NPE has no incentive to focus its efforts on legitimate licensing demands and every incentive not to do so. The greater the number of patents with respect to which the NPE makes licensing demands, and the greater number of companies targeted with respect to each patent, the more “chances” the NPE has to obtain a licensing payment. And the incremental cost of each licensing demand is extremely low.

The same is true with respect to litigation. The NPE has an incentive to file a lawsuit with respect to the most marginal of claims. Its costs will be very low. Document production for an NPE can be trivial while it can easily cost a large practicing company in excess of ten million dollars. Legal fees for a large practicing entity in a complicated case can easily exceed \$10 million per year, and many members of the Coalition for Patent Fairness have tens of lawsuits going at any time. One typically has about fifty in any one year. Thus, the costs imposed on defendants will be substantial and the risk to each defendant of a huge jury verdict because of the vague reasonable royalty standard cannot be discounted. Knowing this, as shown by the list of cases set forth above, NPEs often sue a dozen or more practicing companies in one lawsuit. Incentives become even more distorted with added complexities of multiple defendant cases with aggregated defense fees running into the tens of millions of dollars per year. As a result, the possibility of settlement payments from at least few defendants is quite reasonable.

³¹ *Id.*

Some opponents of reform contend that there are only a few examples of large litigation awards, and therefore insufficient evidence of problems in the system that warrant Congress's attention. But few cases of any type are litigated to a verdict in our system; most are settled. The risks of the litigation process are, of course, key influences on the settlement process. It is the threat of high litigation costs and an exorbitant verdict that enable NPEs to coerce large settlements unrelated to the merits of their infringement claims. Indeed, they sometimes are able to obtain payments without even filing a lawsuit.

And the total cost is huge. Dr. Everett Ehrlich, a distinguished economist and former official in the Clinton Administration, has estimated that the total cost of this litigation for technology companies is \$4.6 billion per year, an amount that has *doubled* over the past four years—the period Congress has been considering this legislation. Even if only half of these costs are unjustified, that is \$2.3 billion dollars that is being diverted away from research and development and into litigation costs. That means fewer inventions and fewer new products that create new jobs.

It is important to understand that this problem does not only afflict large companies. Small businesses too are victimized by NPEs. I urge the Committee to read the letter sent to the Senate Judiciary Committee by the Vice President of Foto Time, a small business located in Texas, that was victimized by an NPE lawsuit and forced to settle because it could not bear the costs of litigation, even though “the costs of the settlement have created a financial burden that potentially could cause us to go out of business – costing jobs and negatively impacting the local economy.”³²

³² Letter from Karl Swierenga, Mar. 9, 2009.

Finally, there is one other aspect of the current patent litigation rules that heightens significantly the risk of an excessive jury verdict: the forum shopping that has become rampant in patent litigation. We have all seen the news reports documenting the rapid increase in cases being filed in forums that have nothing to do with the parties or the witnesses. These often obscure forums are being selected for reasons that have nothing to do with cost or inconvenience. Rather, they are selected strategically based on, for example, the win rates of plaintiffs in the forum.³³

Current law provides that a case may be filed in any district in which the defendant has committed an act of infringement; companies whose products are distributed nationwide therefore may be sued in any judicial district in the country. That loose standard leaves plaintiffs with an essentially unlimited choice of forum.

Of course, this imposes substantial costs principally on defendants, who must transport lawyers, documents, and numerous witnesses to the site of the trial – an expense that is multiplied when the trial is located far from the defendant’s place of business.

Plaintiffs appear to focus on jurisdictions that are perceived to be “plaintiff-friendly.” Indeed, data indicates that plaintiffs do in fact prevail more frequently in some jurisdictions than in others—and those are the jurisdictions that are attracting the greatest increase in filings. Combined with the other deficiencies in legal rules, forum-shopping enables plaintiffs to increase the pressure to settle.

Some opponents of venue reform argue that the Federal Circuit’s recent decision in *In re TS Tech USA Corp.*, shows that the courts are addressing the problem of forum shopping and legislative

³³ Belanger, et al., Strategic Considerations in Forum Selection, http://www.aipla.org/Content/ContentGroups/Speaker_Papers/Mid-Winter1/20063/BelangerDOC.pdf at 17.

action is no longer needed. Although *TS Tech USA* is a step forward, the courts' ability to address this problem is limited by current law. That limitation is shown by the Federal Circuit's subsequent decision in *In re Telular*, where the court denied relief because the defendant was not able to identify a single other forum that was clearly more convenient forum than Texas since witnesses were in Atlanta and Illinois

In addition, NPEs already have taken steps to circumvent the *TS Tech* ruling by, for example, transferring patents to shell companies incorporated and "headquartered" in the local forum just prior to filing suit. Clear venue rules are needed to prevent forum shopping and restore fairness to patent litigation.

I look forward to answering the Committee's questions