



Mark Chandler
Senior Vice President Legal Services, General Counsel and Secretary
Cisco Systems, Inc.
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Chairman Conyers, Ranking Member Smith, Members of the Committee:

I am Mark Chandler, Senior Vice President, Legal Services and General Counsel of Cisco Systems. I am honored to appear before the Committee today to testify in strong support of H.R. 1260, the Patent Reform Act of 2009.

Cisco's success as a company is a direct result of our ability to innovate. Our products originally were designed for communications within private or enterprise networks. When the public Internet emerged in the mid 1990s, our products found immediate application for worldwide use. Today's Cisco's networking equipment forms the core of the global Internet and most corporate and government networks. We have 67,000 employees, including over 24,000 engineers, of which over 14,000 are here in the United States. We invest over \$5 billion each year in research and development to create the next generation of networking equipment.

The patent system provides an essential incentive for innovators like Cisco. Our company holds over 5,000 issued U.S. patents, and we have over 5,000 more applications pending. Cisco believes in strong protection for intellectual property and has both licensed key patents for significant revenue and invoked its rights as a patent holder to prevent infringement of its inventions.

We believe that granted patents should be of high quality and that the patent law should function well and function fairly to ensure inventive genius is fully protected. The reforms contained in H.R. 1260 are essential to remedy the defects that are preventing our current patent system from achieving these goals.

In 2007 the House made it clear that comprehensive patent reform is urgent and necessary. In the spring of 2007, this Committee, under your leadership Mr. Chairman

and that of Mr. Berman, Mr. Smith, Ms Lofgren, Mr. Boucher and Mr. Goodlatte and others, reported favorably H.R. 1908, a bill we strongly supported. In the fall of that year, under the leadership of Speaker Pelosi, the House passed the bill by a strong bipartisan vote.

This session of Congress, you Mr. Chairman and your House colleagues introduced H.R. 1260, which closely resembles the bill passed by the House in the last Congress. We strongly support its enactment.

Since this Committee last held a hearing on patent issues we have seen important developments. Our economy has slowed dramatically, and millions of jobs have been lost. The economic crisis makes enactment of effective patent reform even more urgent. Put simply, at a time when our country must do everything it possibly can to stimulate economic growth and job creation, the flaws in our patent law drain resources from research and job creation to defending unjustified patent suits. The longer we wait to address these widely acknowledged problems, the more we will sap the innovation potential of my industry and deprive our economy of the resulting job creation and growth.

We support HR 1260, The Patent Reform Act, because it will strengthen the patent system in three basic ways:

- By harmonizing U.S. law with the standards applied by our major trading partners;
- By improving patent quality through improvements to processes at the Patent and Trademark Office, therefore reducing the number of poor quality patents; and
- By clarifying vague and uncertain litigation standards to ensure that patent litigation neither overcompensates nor under-compensates plaintiffs and the governing rules discourage, rather than encourage, the filing of abusive lawsuits.

There is widespread consensus on the so-called “first to file” provisions of the bill, although one such aspect of H.R. 1260 requires further attention. The bill as introduced does not take into account the interests of persons who have in good faith made use of technology which they independently developed before the patent application is filed by the person who ultimately receives the patent. We urge you to add protections for such persons that are judicious and fair in those instances when their prior use has been in good faith—protections that are included in virtually every other country’s first to file systems.

With respect to the patent quality provisions, there also is a broad consensus. We are very much encouraged that the Senate has seen fit to adopt the House passed provisions on post grant oppositions and inter partes re-exam.

I would like to focus my testimony on the third area—clarification of vague and uncertain litigation standards—because congressional action to address this issue is essential if we are to eliminate the current unjustified burden on innovation and job creation.

Our company and technology companies like us have been victimized by a growing wave of patent claims. A recent survey of leading technology companies shows that since 2004, licensing requests have increased approximately 650%. In the same period, suits actually filed have nearly doubled. In a study released last month, Dr. Everett Ehrlich estimated that the total cost of these claims for companies in the technology sectors amounted to \$4.6 billion dollars in 2008, *double* the \$2.3 billion they cost just four years earlier.¹ The number of defendants named in patent suits has quintupled in the last 18 years. Increasingly, our courts have become a magnet for suits by foreign patent holders who prefer to sue US companies in our courts than in their own countries. In the last five years, French, German, Australian and Israeli patent holders have broadly sued across the industry, including my company, draining our country of important R&D resources at a time they are desperately needed.

What is the reason for this dramatic change? There simply is no reason to believe that infringing activity has suddenly surged in the last five years.

The evidence suggests the change is attributable to one factor: the imbalance in the patent litigation rules, which has spurred the rise of the non-practicing entity (“NPE”) model, whereby litigation syndicates are created, with no intention to use the patents as the basis for innovation, product development or manufacture. In contrast, until ten years ago, the vast majority of technology industry patent litigation involved competitors who were bringing products to the market. In Justice Kennedy’s words, “*An industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees.*”²

The survey of technology companies reveals that that 88% of the licensing demands and lawsuits came from NPEs. That is consistent with other data in a recent study by Dan McCurdy published by the Center for American Progress, showing that litigation involving NPEs exceeded 10 percent of all patent lawsuits in 2006 and 2007, *quadrupling* the level between 1994 and 2002.

There is nothing wrong with the NPE business model—one of the great virtues of our capitalist system is that it enables entrepreneurs to exercise their creativity to create new businesses, and patent licensing is an important part of that entrepreneurial culture.

But the current surge of royalty demands and lawsuits is a direct result of weaknesses in the patent system— first, the difficulties in having effective reexamination of unmeritorious patents by the PTO and the presumption of validity that applies in court, and second, the threat of significant litigation costs, and the risk of a huge jury verdict. These two elements combine to create a toxic mix that leads to very substantial pressure to settle even unmeritorious suits, which then feeds a new cycle of demands.

¹ Everett Ehrlich, “Economic Effects of Clarifying the Standard for Assessing ‘Reasonable Royalty’ Damages Under Patent Law” at 4-5 (March 2009 Preliminary Analysis) (estimating that half of technology sectors’ costs amounts to \$2.3 billion).

² *eBay Inc. v. MercExchange LLC*, 126 S.Ct. 1837, 1842 (2006) (Kennedy, J., concurring) (emphasis added).

The problem that we face is that the patent system's litigation rules were designed for the pre-NPE world, in which claims typically were filed by practicing entities, such as Cisco, whose patents were being infringed by a competitor. The protections that were effective in preventing practicing entity plaintiffs from filing unjustified, opportunistic claims are not effective against NPEs. Far from deterring the filing of such claims, the current rules actually *encourage* NPEs to pursue these opportunistic lawsuits.

First, NPEs by their very nature, since they manufacture no products, cannot seek lost profits damages. Lost profit damages require clear proof of market demand, and tend to be naturally self-limiting. Instead, NPEs can only utilize the reasonable royalty standard. This standard—based on the 15 so-called “Georgia-Pacific” factors—is vague and uncertain. As Paul M. Janicke, of the University of Houston Law Center, stated: at an FTC Roundtable, “[F]or some reason we’re still using the Georgia-Pacific grab bag, where the judge throws the grab bag to the jury and says do what you think is right. ... I think that should be abandoned.”

The threat of a “jackpot” award is real. Prior to 1990 there had been only one patent damages award in history larger than \$100 million; in the past seven years, there have been at least fifteen judgments and settlements in that category, and at least five that topped \$500 million. NPEs invoke this risk to demand substantial settlements, even in unjustified cases. Each jackpot result encourages more NPEs to bring lawsuits.

Second, as the Federal Trade Commission has pointed out,³ NPEs are different from other types of plaintiffs that invoke the patent laws because they cannot be deterred from asserting unjustified patent claims by the threat of counter-claims by those that they sue. “[B]ecause these NPEs do not derive any significant portion of their revenue from designing, developing, manufacturing, or selling products, they are essentially immune to counter-assertion claims by the companies from which they seek royalties.”⁴

Third, the NPEs’ incentive to assert infringement claims is amplified by the asymmetric litigation costs borne by the product manufacturers that the NPEs sue. The NPE/plaintiff’s costs are minimal—information relating to the patent. It has no product-related information to produce. *Each defendant*, on the other hand, must bear substantial costs, estimated at around \$5 million per lawsuit. In the case of my own company, I have twice taken cases through jury trial at a cost of over \$20 million in each case, because I refuse to allow us to be victimized by bad patents. But the cost keeps rising.

It is important for the Committee to recognize that this is not an abstract debate about legal rules. Reform is urgently needed because the very real costs that unjustified lawsuits—and the unjustified claims that may be settled before they even turn into lawsuits—impose upon companies such as Cisco are hurting our economy. Companies with a successful history of creating large numbers of jobs here in America by bringing to

³ FTC IP Report, ch. 2, at 31-32.

⁴ McCurdy, “Patent Trolls Erode the Foundation of the U.S. Patent System,” available at www.scienceprogress.org/2009/01/patent-trolls-erode-patent-system.

market innovative products and services are being forced to divert resources away from innovation and into unjustified litigation, including unwarranted settlements. Each diverted dollar means less innovation and less job creation. And the fact that our company, and the others like us, must factor into our product development decisions the costs of unjustified litigation means that some products that are developed will not be brought to market.

Dr. Ehrlich's study quantified the impact of this diversion of resources. He examined the question of how many jobs would be created by clarifying the reasonable royalty damages standard. His study concluded that in the technology sector alone, 100,000 jobs would be created over five years. And if we do nothing, his conclusion is that our economy could lose as many as 150,000 jobs over the same period from the continued adverse effects of the existing legal standard.

And this issue is not simply about jobs—as important as job creation is in our current economic situation. It also is about America's continued technological leadership. Less resources for research and development means that the next key invention may be discovered in Europe, or in India, or in China, not in our country.

I recognize that there is a debate about the best way to modify the solutions contained in H.R. 1260 in order to eliminate the vagueness and uncertainty of the reasonable royalty standard. We believe the language of HR 1260 is an appropriate way to address the problem.

As I have noted already, most patent owners do not abuse the system. The source of the problem is primarily non-practicing entities, though some manufacturers certainly piggyback on the imbalanced system. We remain flexible and open to suggestions that address the actual problem and are eager to reach consensus on a way to prevent this drain on job creation and also preserve America's leadership.

Thank you and I look forward to answering your questions.