ELECTRONIC FRONTIER FOUNDATION

Committee on Commerce
Subcommittee on Consumer Protection, Product Safety, and Insurance
U.S. Senate

Hearing
"Demand Letters and Consumer Protection: Examining Deceptive Practices by Patent Assertion Entities"

Testimony of Julie P. Samuels
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Mark Cuban Chair to Eliminate Stupid Patents
Electronic Frontier Foundation

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Chairman McCaskill, Ranking Member Heller, and members of the subcommittee, thank you for holding this hearing and inviting me to testify today about deceptive practices by Patent Assertion Entities. We are greatly encouraged by your interest in this important issue and its impact on consumers.

I am a Senior Staff Attorney at the Electronic Frontier Foundation, where I also hold the Mark Cuban Chair to Eliminate Stupid Patents. EFF is a non-profit civil liberties organization that has worked for more than 20 years to protect consumer interests, innovation, and free expression in the digital world. Founded in 1990, EFF represents more than 24,000 active members. Many of those members are small innovators and tinkerers who often find themselves facing patent litigation or demands. Through litigation, the legislative process, and administrative advocacy, EFF seeks to represent those members' interests and promote a patent system that facilitates, and does not impede, what the Constitution defines as "the Progress of Science and useful Arts."

PAEs use the threat of patent litigation to extort settlements in the form of what they might call "licensing deals." These "licensing deals," however, are not the kind of responsible technology transfer that benefits consumers. These companies, also known as non-practicing entities (NPEs) or, colloquially, as patent trolls, usually neither make nor sell anything but use patents to sue, and threaten lawsuits upon, unsuspecting businesses. As Judge Posner of the Seventh Circuit Court of Appeals explains, patent trolls "are companies that acquire patents not to protect their market for a product they want to produce—patent trolls are not producers—but to lay traps for producers, for a patentee can sue for infringement even if it doesn't make the product that it holds a patent on."[1]

Patent trolls are causing enormous harm to innovators and consumers, not to mention job creators. Companies that actually create products, services, and jobs find themselves under siege by trolls who purchase vague and overbroad patents to launch or threaten lawsuits. As you know, the conduct surrounding those lawsuits, and solutions to

[1] Richard A. Posner, *Why There Are Too Many Patents in America*, The Atlantic (July 12, 2012), http://www.theatlantic.com/business/archive/2012/07/why-there-are-too-many-patents-in-america/259725/.

curb further abuse, are being considered in both chambers of Congress.[2] The harm to consumers, however, does not only arise out of actual lawsuits; instead, it also comes from dangerous and irresponsible demand letter-writing campaigns. Indeed, as the White House found: "The PAE business model is based on the presumption that in many cases, targeted firms will settle out of court rather than take the risky, time-consuming course of allowing a court to decide if infringement has occurred."[3]

These demand letters are often vague, lacking basic detail of what the recipient does to allegedly infringe the patent at issue. The letters frequently list patent numbers without detailing which parts of the patent—which typically comprises many pages of dense technical content and legalese— are at issue. While the recipient of the letter, most often an entrepreneur focused on building her business, has no legal obligation to reply, she might not know that, and the senders often include "draft complaints" and other enclosures in an attempt to threaten real litigation, even though the patent holders may have no intention of actually bringing a suit in court. And this is no wonder, as the letters' targets are ever more frequently individuals and small companies whose entire annual revenue would not cover the cost of a lawyer's time to obtain the information necessary to respond to the letter.

To understand the threat to consumers that irresponsible demand letter practices pose, one first must understand the harms that flow from current patent litigation trends. Since 2002, litigation at the hands of patent trolls has grown from just five percent of total patent litigation to a majority of all patent cases.[4] Moreover, patent trolls are targeting smaller companies, such as startups, that lack the resources to defend against a patent suit (which can cost well over $1 million per side) and thus have no choice but to pay extortionate settlement demands.[5]

This explosion of patent troll litigation has been very costly. The research shows that "NPE lawsuits are associated with half a trillion dollars of lost wealth to defendants

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[2] *See, e.g.,* The Innovation Act of 2103 (H.R. 3309); The Patent Quality Improvement Act (S. 866); and the Patent Abuse Reduction Act (S. 1013).

[3] Executive Office of the President, *Patent Assertion and U.S. Innovation,* at 12, http://www.whitehouse.gov/sites/default/files/docs/patent_report.pdf

[4] James Bessen, Jennifer Ford and Michael Meurer, *The Private and Social Costs of Patent Trolls*, ("Bessen 2011") at 7, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1930272; Colleen V. Chien, *Patent Assertion Entities*, presentation to the December 10, 2012 DOJ/FTC Hearing on PAEs, ("Chien Slides"), at slides 23-24, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2187314.

[5] Colleen V. Chien, *Startups and Patent Trolls* (Santa Clara Univ. Sch. of Law Legal Studies Research Paper Series, Accepted Paper No. 90-12, 2012), ("Chien 2012"), http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=2146251.

from 1990 through 2010. [And] during the last four years the lost wealth has averaged over $80 billion per year."[6] The burden of patent troll litigation falls particularly hard on small companies. Professor Colleen Chien recently found that at least 55 percent of unique defendants in patent troll suits have revenues under $10 million per year.[7]

Of particular note, the patent troll problem is quite often a software patent problem. Software patents serve as an attractive tool for patent trolls because they are notoriously difficult to interpret—giving unscrupulous patent owners the ability to claim that their patent covers a wide range of technology.[8] Thus, litigation involving software patents has increased dramatically—from fewer than 200 per year prior in 1997 to the current rate of over 1000 per year.[9] Many of these suits are brought by patent trolls. In fact, more than 80 percent of troll-filed suits assert high-tech patents, and more than 65 percent have software-related claims.[10] For the same reasons that software patents and their "fuzzy boundaries" result in an increase in litigation, they too provide patent holders a dangerous tool to send menacing demand letters.

Another dangerous demand-letter trend, too, has its roots in litigation, but directly results in extraordinary harm to consumers outside of the courtroom. PAEs now make a regular practice of targeting those who use generally available technology. In fact, six of the top ten largest patent litigation campaigns targeted end users and not the manufacturers or suppliers of the supposedly infringing product or technology."[11] And the research shows that:

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[6] Bessen 2011 at 2.

[7] Chien 2012 at 1-2.

[8] In other words, "software patents have 'fuzzy boundaries': they have unpredictable claim interpretation and unclear scope . . . and the huge number of software patents granted makes thorough search to clear rights infeasible, especially when the patent applicants hide claims for many years by filing continuations. This gives rise to many situations where technology firms inadvertently infringe." Bessen 2011 at 23.

[9] James Bessen, *A Generation of Software Patents*, 18 B.U. J. Sci. & Tech. L. 241, 259 (2012) (Figure 3).

[10] *See* Brian J. Love, *An Empirical Study of Patent Litigation Timing: Could a Patent Term Reduction Decimate Trolls Without Harming Innovators?* (August 30, 2011), at 39, http://ssrn.com/abstract=1917709 (forthcoming in University of Pennsylvania Law Review).

[11] Colleen V. Chien and Edward Reines, *Why Technology Customers are Being Sued En Masse for Patent Infringement & What Can Be Done,* Santa Clara University School of Law Working Paper No. 20-13 (August 2013) ("Chien & Reines") at 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2318666.

> The burden for these suits falls disproportionately on small companies, and too often results in nuisance settlements based on the high cost of defending a patent case, not the merits of the claim.[12]

Even worse, many of these letter recipients are not what we commonly think of as "technology companies." Instead, they merely use technology, as we all do. In fact, retail is "among the most highly pursued industries" by PAEs.[13]

Because the use of technology is widespread, so is the harm from these types of patent demands. "Indeed, many businesses have stopped adopting technology altogether to avoid patent infringement claims—for example, scanning to a USB stick to avoid infringing a PDF machine patent, not offering Wi-Fi to customers to avoid Wi-Fi patents, or, in some cases exiting the business or business line."[14]

Even though a demand letter is not a legal complaint, and even if it makes specious claims, the mere threat of litigation brings with it serious costs. As one study found:

> Patent demands can be costly to resolve, and particularly so for small companies. The overwhelming majority of companies said that resolving the demand required founder time (73%) and distracted from the core business (89%); most experienced a financial impact as well (63%). However, responses and the costs of these responses ran the gamut; for example, 22% of those surveyed said they "did nothing" to resolve the demand.[15]

Mere threats can cause this harm because the costs of patent litigation are, simply, outrageous. If taken to verdict, defending a lawsuit can easily cost nearly $3 million.[16] Even if the case is dismissed early, legal costs will often run into the six and seven figures.[17] Thus, when facing a vaguely worded demand letter that threatens immediate suit and the expensive and unpredictable world of litigation, it is no wonder that so many recipients will merely pay the troll, *even when the PAE may have no intention of ever bringing a lawsuit*.

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[12] *Id.* at 4.

[13] *Id*. at 8.

[14] *Id.* at 12.

[15] Chien 2012 at 10.

[16] *See* http://news.cnet.com/8301-32973_3-57409792-296/how-much-is-that-patent-lawsuit-going-to-cost-you.

[17] Chien & Reines at 3.

These harms are not abstract. They affect real people everyday. Like Mark Egerman, founder of Cover. Cover is a smartphone application ("app") that allows customers to easily split and pay their bills at restaurants. According to Mr. Egerman,

> When we launched in October, we were thrilled by the support we got from restaurants and users. Unfortunately, the press attention brought with it something else—our first patent troll. Within days of launching we received a threatening letter asking us to license a patent or else lawyers would get involved. The patent doesn't address our product and yet we find ourselves in the same unenviable position of hundreds of other startups. Pay off the troll or face an unnecessary lawsuit.

Another app developer, Gedeon P. Maheux, found himself in a similar situation:

> [We] and several other companies were threatened by a well-known patent troll for a patent we (and thousands of other software developers) supposedly violated dealing with in-app purchases in iPhone apps. … At first we decided to use legal means to fight the troll. We hired a lawyer who informed us of our options. … The troll demanded payment by a given date and unless we were prepared to go to court, we had to comply. We're a small business and quickly found our mounting legal fees becoming unreasonable. In the face of [the slow legal system] and increasing costs dealing with the troll, we decided as a group to take the license and pay the troll his toll.

En masse, these threats wreak havoc on consumers. Take Innovatio, a company that, "using a portfolio of 31 patents directed at the 802.11 wireless communication standard (most of which are expired or lapsed) … has made demands of over 13,000 small and large end-users of wi-fi technology using devices sold by Cisco, Netgear, Apple, and others."[18] In less technical terms, this means that coffee shops, hotels, and other small retailers who have bought a $40 router off-the-shelf at their local retailer find themselves facing letters with ominous warnings threating expensive litigation.

Or, MPHJ, a PAE that has sent letters to thousands of small businesses around the country demanding steep license fees for the use of standard office scanners.[19] MPHJ's practices are particularly egregious—it has created a series of shell corporations with nonsensical names like AdzPro, GosNel, and FasLan, making them nearly impossible to track. MPHJ demands approximately $1,000 per employee who uses simple scanning technology—a claim that surely implicates office workers across the country

[18] *Id.* at 19.

[19] *Id.* at 10.

MPHJ sends demand letters (including letters with draft complaints attached) without any apparent intent of ever suing; indeed, there is no record that a single suit has been filed. MPHJ's practices have drawn the attention of at least three states' Attorneys General. In Vermont, the Attorney General sued MPHJ, claiming that its actions demonstrate unfair trade practices in commerce and deceptive trade practices in commerce.[20] That suit is ongoing. Minnesota's Attorney General reached a consent decree with MPHJ prohibiting the PAE from sending correspondence to anyone in the state that seeks fees or payments or threatens litigation in connection with intellectual property infringement, unless MPHJ gives 60 days' written notice to the Attorney General or obtains consent.[21] And, finally, Nebraska's Attorney General issued a civil investigative demand and cease and desist letter to Farney Daniels, one of MPHJ's law firms, who also represents another notorious PAE, Activision, in Nebraska.[22] Farney Daniels has sued over the propriety of the cease and desist order and that litigation is ongoing.

Massive PAE demand-letter campaigns like these lead to additional problems surrounding the sharing of and reporting on information. Because the demands by definition exist pre-complaint, they create no public record. And once a license or settlement is signed, it most likely will include a non-disclosure provision leaving the recipient unable to share its experience. This causes two problems: asymmetry of information and underreporting.

The asymmetry of information problem is simple: the PAE holds all of the information surrounding its threat while the recipient is left with almost none. Without simple facts about the alleged threat it faces, such as who is really behind the demand and if the PAE's history makes it likely to further pursue its threats, a demand recipient is unable to assess its risk. It is left with a host of undesirable options: to hire a lawyer, to pay the PAE to go away, or to do nothing and simply hope the PAE disappears. In most instances, the PAE risk was not one that the recipient bargained for when it bought the product at issue or started its business, yet it finds itself with no choice but to face it.

The second problem is underreporting. Because the vast majority of the deals entered into between PAEs and their targets are not public, the exact scope and contours of PAE activity is difficult for policymakers and others to properly understand.

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[20] *See* http://www.atg.state.vt.us/news/vermont-attorney-general-sues-patent-troll-in-groundbreaking-lawsuit.php.

[21] *See* http://www.ag.state.mn.us/Consumer/PressRelease/130820StopPatentTrolling.asp.

[22] *See* http://www.ago.ne.gov/resources/dyn/files/1069520z2e735d6e/_fn/071813+Bruning+Patent+Troll+Release+.pdf.

To combat these concerns, EFF, along with a broad coalition, launched Trolling Effects, a database to collect demand letters.[23] The site was officially launched on July 31, 2013. The site allows demand letter recipients to post the documents online, find letters received by others, and research who is really behind the threats. The site also features comprehensive guides to the patent and additional relevant information. Finally—and most importantly—all of the information is freely available, not only to those who receive PAE demands, but to academics, policy makers, and the general public.

Our experience thus far with Trolling Effects has taught us that many demand recipients are often not willing or inclined to publicly share their letters. This has to do in large part with the public nature of the database and the fact that, even with redactions, it is virtually impossible to safely anonymize letter recipients. Demand recipients, both large and small, often chose to keep their identity hidden.[24] Larger, more established companies fear that making these demands public "paints a target on their back." Smaller companies and individuals are often even more afraid. It appears that ensuring more thorough transparency will require action from Congress.

Statutory Intervention is Necessary to Protect Consumers

While questions of patent law usually find themselves before the Judiciary Committee, this Committee should consider and correct the negative impact that demand letter-sending practices have on consumers. Those practices can be regulated without disrupting the underlying patent laws and without negative impact on responsible technology transfer. Below, we set forth some potential targeted legislative solutions.

A. Defining Relevant Practices that Violate Consumer Protection Statutes.

Section 5 of the FTC Act declares unlawful "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce." 15 U.S.C.A. § 45(a)(1). Abusive demand letters are both an unfair method of competition and a deceptive practice. A law defining those practices as such would trigger not just Section 5, but many similar state law provisions already on the books.

There can be no doubt that PAE actions cause significant economic harm. According to a congressional study, PAE activity cost defendants and licensees $29 billion in 2011, a 400 percent increase over $7 billion in 2005, and the losses are mostly

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[23] *See* https://www.trollingeffects.org

[24] Professor Robin Feldman came to a similar conclusion: "for a number of years, companies have been reluctant to speak to reporters or researches, partly out of fear of retaliation by large players with large patent portfolios." Robin Feldman, *Patent Demands & Startup Companies: The View from the Venture Capital Community* (Oct. 29, 2013) ("Feldman") at 29, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2346338.

deadweight, with less than 25 percent flowing to innovation and at least that much going towards legal fees.[25] Moreover, a recent survey found that 74 percent of venture investors "reported that patent demands had either a highly significant or a moderately significant impact on the companies that received them, including distracting management, expending resources, or altering business plans."[26] The demand activity in these reports is not limited to letters, of course. But the demand letters do extract their toll, and make up a significant portion of those costs. For instance, Professor Colleen Chien has reported that there are at least 100 demand threats for each filed lawsuit.[27]

The FTC Act was enacted to protect consumers from the type of demand-letter practices many PAEs have lately practiced. By statutorily defining certain of those practices as "unfair methods of competition" or "unfair or deceptive acts or practices," Congress could trigger existing Section 5 protections.[28] For instance, the following type of demand-sending behavior might be addressed:

- Demands falsely threatening litigation;[29]
- Demands sent without specifically listing the patents and claims that are allegedly infringed;
- Demands sent without listing the products and services that allegedly infringe those patents;
- Demands sent without any clear indication of who owns the patent at issue;
- Demands sent following a failure to perform any pre-demand investigation into the recipient; and

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[25] Brian T. Yeh, Cong. Research Serv., R42668, *An Overview of the "Patent Trolls" Debate*, (2012) ("Yeh") at Summary and 2, https://www.eff.org/sites/default/files/R42668_0.pdf (citing James Bessen & Michael Meurer, *The Direct Costs from NPE Disputes* 2, 18-19, (Boston Univ. School of Law, Law and Economics Research Paper No. 12-34, 2012) ("Bessen 2012")), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2091210

[26] Feldman at 39-40.

[27] Chien Slides at slide 25.

[28] FTC Chairwoman Edith Ramirez said in a recent speech she believed Section 5 authority could reach certain PAE activities, such as those "that target small businesses with false claims made to induce the payment of illegitimate licensing fees." Opening Remarks of Chairwoman Edith Ramirez, Competition Law & Patent Assertion Entities: What Antitrust Enforces Can Do (June 20, 2013) at 9 http://ftc.gov/speeches/ramirez/130620paespeech.pdf.

[29] *See, e.g.,* The Federal Fair Debt Collections Practices Act, 15 USC § 1692(e), limiting the scope of threats that can be made in a debt collection letter.

- Demands sent to businesses with the direct knowledge that those businesses can neither afford to take a license or defend themselves in federal court.

PAEs routinely send demands that do all of these things. They leave recipients without any meaningful information on how to mitigate and manage their risk, and leave them oftentimes with little choice but to take an unearned license. This is precisely the kind of behavior that may and should be regulated by consumer protection statutes. As the Commission itself has stated, it can target "[c]onduct that results in harm to competition, and in turn, in harm to consumer welfare, [which] typically does so through increased prices, reduced output, diminished quality, or weakened incentives to innovate."[30]

Defining the types of practices that PAEs like MPHJ rely on as unfair or deceptive practices would allow the FTC and various states with statutes similar to Vermont's to take advantage of existing statutory frameworks and end the dangerous PAE demand-sending campaigns. Moreover, it would present no risk to companies who engage in responsible licensing practices and technology transfer, who could easily obtain the information necessary to conduct proper business.

B. Creating Public Registries of Relevant PAE Information

Because a patent is a government-granted monopoly, the government may impose conditions on that grant. Indeed, it does that all the time by requiring that certain conditions be met before a patent is granted and that patent holders keep their records up-to-date by, for instance, reporting on changes in ownership. Likewise, a patent holder should be required to provide certain information to the Patent Office when it asserts infringement of that patent in a letter.

Patent owners could be required to report information such as how many demand letters have been sent regarding a specific patent; identification of all parties who stand to benefit financially from any resulting license; identification of any obligation to license the patents at issue on fair or reasonable terms; and how many times the holder has filed suit based on the patent at issue.

There are various reasonable triggers that could require such reporting, such as a certain number of letters sent in a set period of time or notification to the Patent Office of a threshold number of letter recipients.

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[30] Statement of Commissioner Joshua D. Write, Proposed Policy Statement Regarding Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act (June 19, 2013) at 7, http://www.ftc.gov/speeches/wright/130619umcpolicystatement.pdf.

At a minimum, reporting this information to the Patent Office would make it public (assuming the Patent Office provided it in a publicly-accessible database, which it should be required to do). This information would fundamentally change the unfair information asymmetry facing demand recipients—armed with more facts, they will be better able to assess their options.

Collecting the information might also assist the Patent Office in initiating *sua sponte* review of certain patents. If the Office has information regarding which patents are most often used as weapons by PAEs, it might prioritize those for such review. Indeed, in a world with literally millions of existing patents, it makes sense to focus challenges on those that pose the greatest threat to consumers.[31] It is not until those patents are asserted in demands that we can ascertain just which patents will cause harm. Requiring reporting to the Patent Office will give the Office necessary knowledge to know which patents make the most sense to target for additional review.[32] (The potential for Patent Office review of existing patents may likewise serve as an incentive for demand-letter recipients to provide information as well.)

It is not just the Patent Office who may decide to subject existing patents to additional review (indeed, this is a very rare practice, though there is no reason it cold not happen more). It also gives third parties—including public interest groups like EFF—knowledge surrounding which patents they might choose to challenge. EFF alone has made more than 15 third-party patent challenges to patents and patent applications, one as recent as October of 2013. These challenges require significant resources, both financial and otherwise, and it is of great benefit to know which patents pose the greatest threat to consumers, end-users, and those who may not be in a position to put forth such a challenge themselves.

In the alternative, the FTC could also house a similar registry of patent demands. It already does this in various other contexts, such as the Do Not Call Registry. When a certain threshold number of demands are sent involving a particular patent, or from a particular sending party, the FTC might initiate an investigation. Similar to a registry at the Patent Office, one at the FTC might be made up of patent holders self reporting or consumers submitting information on the demands they receive. Given the FTC's expertise in consumer-facing issues, it would be particularly equipped to house the latter type of registry; given the Patent Office's expertise in dealing with patent owners, it might focus on the former.

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[31] Dan L. Burk & Mark Lemley, *Policy Levers in Patent Law,* 89 Va. L. Rev. 1575 (2003).

[32] *See* Chien & Reines at 6.

C. Increasing Public-Private Partnerships

In virtually every area of the law there has been a long history of productive public-private partnerships. Patent law is no exception. The Peer To Patent project[33] serves as a telling example. Peer To Patent provided the first "governmental 'social networking' Web site designed to solicit public participation in the patent examination process."[34] After its first two years, Peer To Patent attracted more than 74,000 visitors; of those visitors, more than 2,600 went on the become peer reviewers.[35] Also in its first two years, the project contributed relevant prior art in more than 25 percent of the applications it handled.

EFF envisions a similar partnership with our Trolling Effects site. Trolling Effects may serve as a public-facing database for information collected by the Patent Office or otherwise work with the government to increase the reach and scope of that information. In combination with statutory provisions providing for submission of information, Trolling Effects or a project like it will serve as a powerful tool to curb the current demand letter abuses.

Conclusion

In conclusion, EFF has grave concerns about the impact that PAE activities are having on consumers. The importance of today's hearing on those activities cannot be understated, particularly because PAEs conduct the vast majority of their business behind a veil of secrecy. Individual consumers, small start-ups, and ordinary Americans find themselves facing patent troll threats everyday, yet even the most basic information on those threats is often unattainable. Even just having us here today to talk about this problem is a crucial step toward solving it. We encourage you to continue this important conversation and consider legislative proposals that would limit the harm to consumers from PAE activity, particularly the direct harm that comes from demand letters.

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[33] http://www.peertopatent.org.

[34] Peer To Patent Second Anniversary Report at 4, http://dotank.nyls.edu/communitypatent/CPI_P2P_YearTwo_lo.pdf

[35] *Id.* at 5