Statement for the Record
Senate Judiciary Committee

Hearing entitled
S. 1137, the "PATENT ACT" – Finding Effective Solutions to Address Abusive Patent Practices

May 7, 2015

On behalf of financial institutions of all sizes represented by the undersigned trade associations, we are writing to commend you for your leadership in holding a hearing on S. 1137, the PATENT Act, and we respectfully request that this testimony be included as part of the hearing record.

We commend the bipartisan coalition of cosponsors for their many months of productive work to introduce the PATENT Act. We are encouraged by your efforts and believe it is an important step toward developing a bill that can eventually be enacted into law to help curb abusive tactics of non-practicing entities (NPEs) who use low quality patents to target businesses of all shapes and sizes. However, further work must be done in the area of patent quality to ensure that meaningful opportunities exist for all sectors to have low quality patents review by the experts at the PTO for validity. We look forward to working with the Judiciary Committee as the process moves forward.

Patents and the Financial Services Industry

Litigation by patent trolls against financial services companies has grown at a staggering rate—almost *290%* from 2009 to 2013, based on a review of court records. Moreover, a study by Harvard Business School Professor Josh Lerner found that financial patents are 27 to 39 times more likely to be asserted in a lawsuit than nonfinancial patents.[1]

No type or size of financial institution is immune. NPEs have brought patent litigation against virtually every type of financial institution, including credit unions, community banks, regional banks, payment networks, and insurance companies. In addition, NPEs have sued the federal government related to patents that are financial in nature, including various Federal Reserve banks and even the United States Postal Service. Because of the interoperability of financial patents and the ubiquity of certain technology in the e-commerce and online payments space, virtually any company from any industry has been targeted or is at risk for being a target in the future.

Assertions of low quality patents by NPEs against financial institutions not only increase expense and distraction for the financial services industry, they also hinder the ability of the sector to help the U.S. economy grow by providing financial services to households and needed

[1] Josh Lerner, *The Litigation of Financial Innovations*, 53 J.L. & Econ. 807 (Nov. 2010).

capital to businesses, especially small business. According to the Small Business Administration, in mid-2014, banks had almost $600 billion in small business loans outstanding.[2] The NPEs that target the financial services industry come in a variety of forms ranging from failed operating companies to sophisticated firms designed to amass and hold patents solely for the purpose of licensing and litigation. As such we believe that a specific definition of NPE is difficult to identify and far less important than the quality of the patents they are asserting and the lack of transparency, honesty and integrity they use to demand payment from others and/or pursue frivolous litigation.

Low quality patents, and the tools used to leverage them, turn into a meritless tax on innovation. This is where we hope Congress will focus their efforts. To that end, we take this opportunity to elaborate on specific aspects of S. 1137 as introduced.

Demand Letter Reform

Your bill would help ensure that demand letters include clear and detailed information, such as the owner of the patent, what entities have a financial interest in the patent, what product or service is allegedly being infringed and how such product or service infringe the patent. However, we believe that the provision could be enhanced by making it clear that the failure to send a clear and detailed demand letter should result in the dismissal of any subsequent civil action by the NPE against the recipient of the vague demand letter.[3]

Too often, NPEs target small business, especially the small financial institutions that tend to be end-users of products and services, with vague and deceptively worded demand letters. These demand letters often lack detail about the owner of the patent and how the patent is being infringed. Such information is critical to determining the nature and quality of the claim contained in the demand letter. Without this information, financial institutions have no way to evaluate the merits of the demand letter. This is particularly true when the financial institution is

[2] U.S. Small Business Administration, *Small Business Lending in the United States 2013* (Dec. 2014). Venture capitalists are an important part of this debate and provide a valuable service to the US economy. That said, so do the financial institutions that provide the credit to our small businesses and job creators across the country. According to National Venture Capital Association (http://nvca.org/pressreleases/annual-venture-capital-investment-tops-48-billion-2014-reaching-highest-level-decade-according-moneytree-report/), venture capitalists invested approximately $48.3 billion in 2014. According to Small Business Association data, there was approximately $589.7 billion in small business loans outstanding in Q4 of 2014, illustrating that small business lending in 2014 is approximately 1110% more than venture capital funding. In addition to loan volume, the number of deals done by financial institutions is much larger than venture capitalist firms. In 2013, venture capitalists funded 4,188 deals. According to the Small Business Administration, banks made almost 23 million small business loans. In the end, banks lend over $500 billion more capital to small businesses than venture capital firms and they also help fund over 20 million more businesses every year.

[3] Additional demand letter reform that the Committee may want to consider include (i) a requirement that demand letters be filed with regulators and recorded in a public, searchable database; (ii) codifying that receipt of a demand letter is a sufficient threat of suit to file a CBM petition; and (iii) clarifying that State laws that have been enacted to curb abusive demand letters by patent trolls are not preempted.

not familiar with the technology or process at issue because the product or service was purchased from a vendor.

Vaguely-worded demand letters have been used by NPEs to coerce licensing agreements and the payment of royalties for low quality patents that are likely invalid and not infringed. As financial institutions have testified before this very Committee, recipients of vague demand letters are faced with a difficult business decision: risk costly litigation to defend against ambiguous, yet ominous threats, or pay a likely unnecessary licensing fee and settle.

Rather than enter a costly and lengthy legal battle, many financial institutions make the economic decision to pay the troll. The NPE then moves on to its next victim. For slightly more than the cost of a stamp and the threat of litigation, NPEs can extract costly settlements from institutions that lack the expertise and resources to fight. Ultimately, these costs are a tax on consumers, stifle innovation, and have the potential to limit product offerings.

Covered Business Method Program

The Financial Services Coalition strongly urges the Committee to include language that would make the CBM program permanent.

1. A Permanent CBM Program is Necessary to Ensure that Meaningful PTO Review is Available for All Patents and All Industries

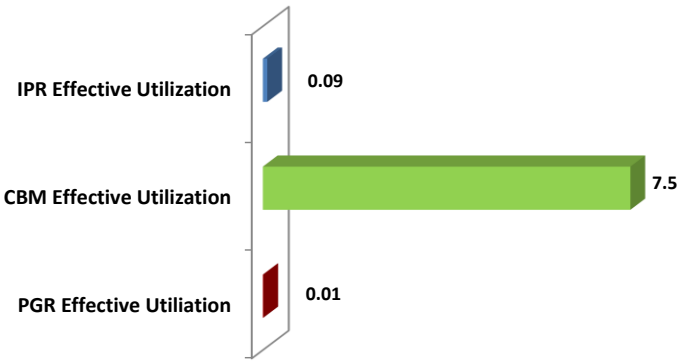
Established in the American Invents Act, the CBM program is a post-grant review program founded on the fundamental principle of fairness that post grant review should be available and meaningful for every party to the US economy.

CBM is the only viable tool for quickly, efficiently and cost-effectively eliminating covered business method patents that are invalid under *Alice* or in light of use and sale prior art. Without CBM, the federal judiciary is the only vehicle for the *Alice* decision and use and sale prior art to be applied to currently issued business method patents.[4]

Invalidity based on § 101 and use and sale prior art are the most common grounds for challenging low quality financial patents. Without CBM, the financial services industry and many other industries that are alleged to have infringed a financial patent, are effectively cut out of post grant review while other industries, that do not predominantly rely on § 101 or use and sale prior art, will continue to enjoy a faster, cheaper and more efficient alternative to District Court litigation through IPR proceedings. To ensure PTO review remains available equally to all industries, CBM should be made permanent.

[4] *Inter Partes* Reivew ("IPR") does not allow for a determination as to whether a patent is invalid under § 101 or under use and sale prior art. *See* 35 U.S.C. § 311(b) While Post-grant Review ("PGR") does allow review based on § 101 and use and sale prior art, PGR is not available for the more than 45,000 business method patents that have already issued. *See* P.L. 112-29, § 6(f)(2)(A); 35 U.S.C. § 321(c).

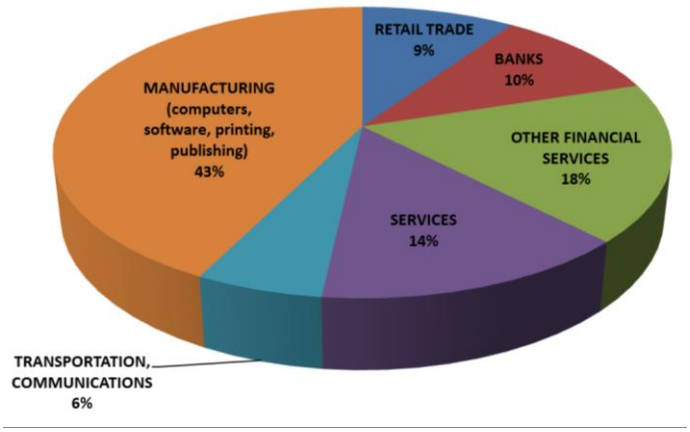
The criticality of maintaining CBM to ensure meaningful PTO review is available for all industries and all patents is evidenced by CBM utilization. Based on the number of patents eligible for each post-grant program, CBM is by far the most utilized of all of the post-grant programs[5]:



In fact, CBM utilization has exceed PTO projections by about 160%.

2. The CBM Program Benefits A Multitude of Industries and Companies

CBM works for all sectors of the economy. Indeed, the vast majority of companies requesting CBM review are not financial services companies. Brick-and-mortar retailers, on-line retailers, airlines, Internet search engines, traditional computer companies and the United States Postal Service have all been petitioners in the CBM program. This chart shows the utilization of CBM by industry:



[5] Program Utilization is the quotient of number of petitions filed and number of patents eligible for IPR, CBM and PGR respectively.

Moreover, the benefit of CBM is not limited to those companies that file CBM petitions. All companies, and by extension the US economy overall, benefit when CBM is used to clean bad patents out of the system. NPEs that abuse the patent litigation system have found that the standardization and interoperability that makes today's system of electronic commerce work also enables them to use the same low quality business method patents to prey upon every sort of business and financial institution from the biggest to the smallest. However, it is this very tactic that allows the benefit of the CBM program to extend far beyond the companies that file CBM petitions. An examination of patents petitioned for CBM review by larger regional banks or integrated financial services institutions shows that many of those same patents have been asserted in lawsuits filed against smaller community banks and credit unions. (See Exhibit A). Similarly, an examination of patents petitioned for CBM review by a range of brick and mortar and on-line retailers have been asserted in litigation against a broad range of companies from hotels, banks, sportswear manufacturers, clothing retailers and others. (See Exhibit B). The CBM performance data clearly demonstrates that the benefits of CBM review extend far beyond CBM petitioners. The collateral benefits of CBM review flow throughout the economy, accruing to every sort of business and consumer.

3. The CBM Program Has Numerous Safeguards to Prevent Abuse

Preserving CBM ensures that there is an efficient, cost-effective alternative to litigation for the review of business method patents. Preserving CBM review will not subject patent holders to harassment or abuse.

There are numerous unique safeguards built into CBM review to prevent the harassment of patent holders and ensure that only those patents more likely than not to be invalidated are subject to review:

- Patents only become eligible for CBM review when the patent holder begins litigation or threatens to do so at a level meeting the declaratory judgment standard. Only at that point can those parties charged with infringement of an eligible patent petition for review under CBM.
- CBM review requires meeting a high bar for review. A petitioner must establish that it is "more likely than not" that the patent is invalid in order to gain admission into the program.
- A petition for review under CBM can only be filed when PGR is not an option, meaning more than nine months after the issuance of the patent.
- Once a party charged with infringement files for declaratory judgment they are barred from petitioning for relief under CBM program.
- Petitioner in a CBM proceeding in which a final written decision is issued, is estopped from raising grounds of invalidity in a District Court proceeding that were raised in the CBM proceeding.
- There is no mandatory stay under CBM.
- CBM-eligible patents do not include patents for "technological inventions."
- Review under the CBM must be completed within one year from initiation of the review and not more than 18 months from the time the petition for review was filed.

These safeguards are working well. For example, to date, approximately 30% of CBM petitions have been rejected.

4. Making CBM Permanent is a Key Tool to Address Patent Quality

Unfortunately, without intervening action by Congress, the CBM program will expire in 2020, once again leaving certain industries exposed to low quality business method patents. There are many existing patents that have yet to be considered by the PTO via the CBM program that would escape review once the program sunsets. In the absence of extending CBM, NPEs are incentivized to simply wait out the program's expiration before emerging to assert low-quality patents. Moreover, the universe of eligible patents has been expanded in the wake of the Supreme Court's *Alice* decision.[6] Currently, subject matter eligibility is the second most common grounds for invalidation in the CBM program. Without CBM, the only option for defendants in cases involving so-called *Alice* patents will be to pay the hold-up fee or engage in costly litigation. Further, the PTO continues to grant additional CBM-eligible method patents that may benefit from CBM review. For these reasons, allowing the sunset to expire will leave businesses in many sectors and of all sizes subject to abusive behavior.

The Financial Services Coalition supports making the CBM program permanent, as it has proven to be a successful, low-cost alternative to litigation of covered business method patents. It makes little sense to leave this successful program to sunset while a dearth of low quality patents litter the IP landscape to be asserted and litigated with a meaningful alternative to court. When post-grant programs with far lower utilization rates and far less stringent gate-keeping enjoy a permanent status, leaving CBM to expire fails the stated intent of many of the bill sponsors who have asserted, correctly, that post-grant must be available to everyone.

Fee-shifting/Cost recovery

We agree strongly that fee shifting is useful to ensure that plaintiffs think twice before bringing meritless litigation. Further, we acknowledge that it is common for trolls to be a shell company (often and LLC) with little more than a post office box and a patent of questionable quality. In these cases it is important that district courts have tools to ensure that fees, once shifted, will be

[6] *See, e.g.,* Professor Mark Lemley of Stanford Law School stated that "I don't think it's all software patents, but I guess what I would say is a majority of the software patents being litigated right now, I think, are invalid under Alice." (http://www.ipwatchdog.com/2014/09/04/the-ramifications-of-alice-a-conversation-with-mark-lemley/id=51023/). Erich Spangenberg, founder of IPNav, recently expressed his view that "the combination of the AIA and recent Supreme Court decisions, especially Alice, have had the effect of wiping out billions of dollars of value in patents, especially software patents. If some of the more recent 101 (what is patent eligible) decisions are upheld, we are only beginning to understand what Alice means." (http://www.ipnav.com/blog/erich-spangenbergs-patent-predictions-for-2015/). Professor David Hricik of Mercer University School of Law commented that "I've been reading a lot of law professor views, and several (if not many) think software patents are dead, or largely so. . . . My guess is Alice is going to cause us all to bang our heads, stub our toes, and wander through Wonderland for many years to come." (http://patentlyo.com/hricik/2014/06/which-mushroom-alice.html).

paid. However, the language included in S. 1137 will have profound unintended consequences if not addressed.

In lending agreements, collateral is a borrower's pledge of specific property to a lender, to secure repayment of a loan. The collateral serves as protection for a lender against a borrower's default—that is, it can be used to offset the loan if a borrower fails to pay back the bank. Intellectual property is one form of collateral. For example, a company that borrows money from a bank typically pledges all of its assets, including its patents, as security for the bank that the loan will be paid back.

Based solely on this security interest in a borrower's patents, a bank may be deemed an "interested party" under the current cost-recovery language and thus liable for a borrower's attorneys fees. This liability shift changes the nature and value of a bank's collateral and, perhaps, the capital a bank is required to hold against the loan. This impact will be felt across the entire loan portfolio of the U.S. banking industry, including SBA loans that have a partial government guarantee.

According to the Federal Reserve, U.S. banks have almost $7.9 trillion in outstanding loans,[7] of which about $600 billion are small business loans.[8] Undermining the patent collateral securing even a small fraction of these loans will have a devastating impact on banks' existing loan portfolios. Not only will the current cost recovery language affect current loan portfolios, it will have a chilling effect on the sectors willingness to lend money to companies that owns patents.

While members of our coalition do not generally provide debt financing to obvious NPEs, if the current cost-recovery language becomes law, banks will be forced to limit lending due to an inability to determine if the borrower is, or will eventually be categorized as, a NPE. Loan underwriting and credit due diligence is done by bankers, not patent lawyers. Moreover, the subjectivity of the determination as to whether a prospective borrower is a NPE is complicated by the fact that no legal definition of NPE exists and troll activity is often in the eye of the beholder. Furthermore, even if a determination could be made with absolute certainty during the initial loan underwriting, a bank cannot prevent a borrower from evolving its business model over time.

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The financial industry is comprised of lenders and insurers and asset managers, small and large, operating across the country that succeed by serving consumers and other businesses. The abusive tactics of NPEs not only impact the financial institutions, but impede their ability to serve these consumers and small businesses.

Small businesses are one such customer of financial institutions, and these businesses stand at the center of today's debate. Opponents of demand letter reform and CBM permanence frame the debate with claims that meaningful reform will diminish intellectual property rights, hurting

[7] *See* http://ycharts.com/indicators/total_loans_and_leases_of_us_commercial_banks.
[8] U.S. Small Business Administration, *Small Business Lending in the United States 2013* (Dec. 2014).

investment in today's small business and entrepreneurs by venture capital firms. The opposite is true. Small businesses and entrepreneurs will be hurt if Congress does not halt the NPEs from targeting financial institutions with low quality patents, deceptive demand letters and frivolous lawsuits.

Small business loans are one product in the suite of important services the financial sector provides to the US consumer and business. Whether it is a home loan or student loan, an insurance product to provide your business economic resiliency during a crisis or your family peace of mind, the financial services sector succeeds when it serves its consumers well.

Unfortunately, NPEs choose to target our institutions (as well as every sort of retailer and internet company) with frivolous demands and abusive litigation based on low quality business method patents.

We appreciate your Committee's leadership to curb abuse arising from the assertion of low quality patents and your work on S. 1137. The Financial Services Coalition believes this is an important step forward, and looks forward to continuing to work with the cosponsors, Judiciary Committee, and Senate to improve the bill as a whole as the process unfolds.

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Thank you again for your leadership on patent reform and for allowing us to submit testimony for the record.

Sincerely,

American Bankers Association
American Insurance Association
The Clearing House Payments Company, LLC
Credit Union National Association
Financial Services Roundtable
Independent Community Bankers Association
NACHA – The Electronic Payments Association
National Association of Federal Credit Unions
National Association of Mutual Insurance Companies