

Testimony of Mr. John Squires  
Goldman, Sachs & Company  
On behalf of:

The American Bankers Association  
The Financial Services Roundtable  
And  
The Securities Industry and Financial Markets Association

“Patent Reform: The Future of Innovation”

The Senate Committee on the Judiciary  
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Chairman Leahy, Senator Specter and members of the Committee, I am John Squires of Goldman Sachs and I appreciate the opportunity to testify today on the critical importance of S. 1145, "The Patent Reform Act of 2007," to the financial services sector.

I appear before you today as chairman of the Securities Industry and Financial Markets Association (SIFMA) Intellectual Property Subcommittee and am also representing the American Bankers Association (ABA) and The Financial Services Roundtable (FSR).

Our respective industry organizations support S. 1145, "The Patent Reform Act of 2007." The issues addressed in the bill, we believe, are precisely the issues that must be addressed to bring a system out of balance, back into balance. We are grateful for the substantial and thoughtful bipartisan, bicameral work already underway.

Patents are still generally new to our industry, but not for the reason most people think. While many people attribute patenting in the financial services sector to the *State Street Bank* decision in 1998, the truth of the matter is that the modern banking and technology needs and the advent of the Internet participants flattened our world almost overnight. Patents and intellectual property aside, we have had to rethink and re-engineer almost every aspect of how we deliver services, serve our clients and add value to stay competitive in a global marketplace. Be it technology push, or innovation pull, we would be here either way.<sup>1</sup>

While patents in our industry do provide substantial benefits and incentives for financial service firms, particularly where open innovation is concerned or transparency desired the more common experience unfortunately has been that the patent system is a legal system in need of substantial reform.

Patent examination quality issues, predatory patent assertions and litigation abuse have precluded continued progress and efficiencies in bettering the U.S. financial system. A recent study by Harvard Business School shows that the financial services industry is *especially* vulnerable to infringement suits and nuisance claims. The Harvard study found that financial patents are 27 times more likely to be asserted in a lawsuit than non-financial patents, and individuals and other non-practicing entities disproportionately own these litigated financial patents.<sup>2</sup> And because patent suits carry the risk of injunction, the delivery of financial services in the U.S. economy is all too easily put at risk. We fear it is only the tip of the iceberg.

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<sup>1</sup> John A. Squires and Thomas S. Biemer, Patent Law 101, Does a Grudging Lundgren Panel Decision Mean the USPTO is Finally Getting the Statutory Subject Matter Question Right? 46 IDEA 561, 563-566 (2006).

<sup>2</sup> "Trolls on State Street?: The Litigation of Financial Patents, 1976-2005." Mr. Josh Lerner. *Harvard Business Journal*

To be clear, our industry does not see itself as an “opponent” of sectors or industries who take divergent views on reform. Published accounts are quick to cast the patent debate as a schism between “tech” and drug and biotech companies, with the financial industry shaded towards the tech side of the debate. But the fact is that FSR, SIFMA and ABA-member organizations finance drug companies and biotech companies of all shapes and sizes. Member firms also provide seed and venture capital to independent inventors and start-ups that help bring their visions to fruition.

All industries do not experience the patent-granting and patent litigation system in the same way; we believe that our industry experiences are different from other sectors. So we have engaged and continue to engage on all fronts.

Over the last three years, we have jointly filed amicus briefs to both the Supreme Court and the Federal Circuit on issues of import to our members. In *eBay v. MercExchange*, we saw the automatic injunction rule create unacceptable operational risks to the financial system. Similarly, we have filed amicus briefs with the Federal Circuit in both *Knorr-Bremse* and in *In re Seagate* concerning willful infringement jurisprudence.

Analogous to an investment portfolio, we view the current patent system as underperforming because it is overweight with an “Industrial Revolution-era” view of the world, and underweight in terms of the robust and complex value drivers of the knowledge economy. The time has come for the patent law portfolio to be rebalanced and we believe the reform bills as introduced will accomplish much of the rebalancing when enacted. To finish my analogy, its time to enable patent law to generate the substantial returns for the U.S economy and American competitiveness that it should.

With respect to patent reform legislation, S. 1145 has several provisions that we strongly support as drafted, and there are others we can support with modifications. For instance, the provisions dealing with damages reform, post-grant review and interlocutory appeal are all necessary to accomplish meaningful patent reform and we support the language in the bill as introduced. However, the provisions clarifying the use of secret prior art, venue, prior user rights and the effective date could be strengthened or improved.

The focus of this hearing is post-grant review, interlocutory appeal and venue so our testimony addresses those issues in order before addressing other issues of equal importance.

### **Post-grant review (Section 6)**

We support strongly the post-grant opposition proceeding in S.1145. The second window is essential to a meaningful, efficient and broadly available reevaluation of suspect patent claims before a firm is forced into prolonged and expensive litigation.

To date, there has been little if any way for industry – any industry for that matter – to practically engage in patent quality. And industry engagement is very important, particularly for the financial service sector; since the Patent and Trademark Office (PTO) has acknowledged that it lacks a suitable prior art database in the area of business methods. While potential troves of prior art may reside within our firms given our industry’s historical lack of patenting, there has never been a balanced mechanism for firms to inject prior art into the system to improve patent quality. As a result, quality suffers.<sup>3</sup>

In today’s information age, the “wisdom of the crowds” – and the prior art they may have – can and should be available to bolster patent quality. While available in theory, the current reexamination processes have generally proved ineffective and are not widely accessible or used. It is probably fair to say that the inter-partes reexamination process in particular, with its draconian estoppel provisions, has been a failure.

S. 1145 addresses these limitations by providing an opposition process where the challenger can fully participate and rely on any evidence of invalidity that would be available at trial. Equally important, the challenger need only prove invalidity under the more equitable preponderance of evidence standard without the presumption of validity that applies at trial.

More importantly, the bill creates an opportunity to utilize this improved opposition proceeding both during a one-year period after the patent is issued and immediately prior to litigation (the “second window”). Even if it were possible to review all of the relevant patents in the first window, it would be impossible to determine how a patentee might interpret and apply the patent, particularly to an expansive, undifferentiated business process.

A second window to oppose, triggered when notice is provided, may be the first and only opportunity for the industry to challenge a patent's validity before the agency best equipped to review the art it has marshaled. Indeed, the second window is the only proposal that addresses this issue and as a practical matter, is the first and only opportunity for financial services firms to ferret out invalid patents before being forced into expensive and prolonged litigation.

### **Interlocutory appeal (Section 10)**

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<sup>3</sup> See, Squires and Biemer, 46 IDEA at 581-85 (2006).

We strongly support language in Section 10 of S. 1145 to create an interlocutory appeal of Markman rulings. Although the proposed language applies the interlocutory appeal only to infringement actions, we favor extending the interlocutory appeal to apply to both infringement actions and declaratory judgments (under 28 U.S.C. 2201).

An interlocutory appeal would help to mitigate the judicial inefficiency that occurs when a full trial is conducted based on an incorrect interpretation of the patent at the district court proceeding and the Court of Appeals for the Federal Circuit (CAFC) modifies or reverses that interpretation and orders a new trial based on that modified interpretation or reversal. The purpose of the Markman ruling is essentially to tell the plaintiff and defendants what the patent means, and as such, the current system is failing litigants. Markman rulings by district courts are being overturned over 35% of the time. The practical effect is that many litigants effectively end up paying the attorney fees and expenses for two trials.

Markman decisions are neither elementary nor run-of-the-mill for most district courts. Many patent cases balance on the highly technical elements of science and patent law. Further, many district court judges see only a handful of patent cases over the course of their entire careers. Often, district court judges employ the assistance of Special Masters, and some Members of Congress have suggested that through the assistance of supplemental experts the complexity of patent cases can be conquered. While the Masters do help, they also add a great deal of cost to the case. Further, the Masters may be – and are – reversed just as the district courts are. The need for immediate CAFC intervention is demonstrated when litigants bend procedure like a pretzel to get a timely review of Markman, such as when litigants are willing to stipulate to infringement simply to get claims questions heard by the CAFC.

Three specific concerns have been raised about interlocutory appeal. First, a flood of appeals will result. Second, that the process will delay and unduly lengthen cases. Third and finally, that appeal will give litigants “two bites at the apple”. It is important to address those concerns.

In terms of workload, experts have asserted that the interlocutory appeal will increase the workload at the federal circuit by as much as 50% in a worst case scenario. Even accepting this worst-case scenario, basic math belies the assertion that the increase will be overwhelming.

The CAFC heard a total of 834 cases in 2006 of which 453 were patent cases.<sup>4</sup> Of those, 259 were adjudicated (57%). A 50% increase would mean an additional 109 cases a year could be attributable to IA. The CAFC’s current workload plus those cases is an increase of roughly 12%, and with four three-judge panels hearing cases, the net is an

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<sup>4</sup> See <http://www.fedcir.gov/pdf/ChartAdjudications06.pdf>

increase of 2 or 3 cases per month, per panel in addition to the roughly 17 cases per month the CAFC currently hears. These numbers do not account for any decrease in caseload resulting from cases that would no longer need an appeal at the end of trial due to IA resolving the issue earlier. Therefore, they are truly a worst case scenario.

Not only is this increase within the 14 percent increase in overall workload the CAFC saw last year, in the context of the other appeals courts, according to GAO, the average caseload per month of the other circuits (including the DC Circuit which hears the fewest) is 47.8 cases per month.

Regarding delay, we believe that the average duration of a district court proceeding is roughly 27 months. The average time to get a decision from the CAFC is 3-6 months (also an estimate), with time to appellate oral argument about 7 months from the final district court judgment. With these numbers in mind, it takes between 37-40 months to get a final determination of what the actually patent means. Allowing the appeal will greatly reduced the amount of time to define the scope of the patent. Once the appeal is ingrained, cases should take even less time. In fact, the mere presence of the interlocutory appeal will likely generate more reasonable settlement requests and an increased number of settlements.

Finally, we agree that provision should not provide litigants with two bites of the apple and agree that legislative language could readily address that threat.

Claims construction is arguably the most important factor in a patent case. It determines the scope of the invention, which relates to both infringement and validity. Under the current system, the CAFC is the final arbiter, and the only court that can provide litigants the certainty and clarity they need to have educated discussions around settlement. The interlocutory appeal proposed in the current bill will not only establish greater certainty, it will establish certainty based on the merits of the case and not by exploiting a district court's unfamiliarity with patent law or the subject matter.

### **Venue (Section 10)**

A central component in reforming the litigation climate is curtailing forum shopping. Certain jurisdictions have apparently become a magnet for patent cases because of the disproportionately high number of cases decided in favor of patentees. One plaintiff alone filed over 50 infringement suits against financial service firms in the Eastern District of Texas, alleging infringement of patents it holds related to electronic check processing. Indeed, the manner in which commercial banks process checks is all but prescribed by the 2004 "Check 21" law that incentivizes electronic imaging. (Pub. L. No. 108-100, 117 Stat. 1177, codified at 12 U.S.C. sections 5001-5018.) As it stands, the cost of check imaging now includes the additional expense of patent infringement claims.

The proposed language in S. 1145 limits venue to locations where the defendant or plaintiff reside or where the defendant has committed acts of infringement and has a regular and established place of business. The redefinition of "resides" is generally consistent with the pre-1988 standard for patent venue and is limited to a firm's state of incorporation or location of principle place of business. While these changes preclude a patentee from suing a firm in a jurisdiction where neither party has a presence, they do not prevent a patentee from bringing suit in a desired jurisdiction once it has established and been incorporated in that jurisdiction.

The proposed language in S. 1145 is an important step forward. We would however, encourage efforts to strengthen the provision to ensure that financial institutions are not subject to litigation in venues where they have no significant business presence and that the incentive is removed for patent holders to "create" a principle place of business in a jurisdiction in order to sue in a particular judicial district.

It is appropriate to create a test whereby both parties have substantial business nexus in the judicial district or otherwise constrained by this statute. Financial firms do not want to be open to suit in any and all districts due simply to the presence of a branch or an ATM. It is unlikely that the provision, as it is currently constructed, will eliminate blatant forum shopping.

### **Prior user rights defense**

We support the expansion of the prior user rights defense to remove "methods." However, the financial services industry continues to need additional language to ensure that a holding company may confer this defense on affiliates and extend protection to those who had reduced the subject matter to practice at least one year prior to the filing date of the patent.

The defense is a personal defense and applies only to "the person who performed the acts necessary to establish the defense..." Uncertainty about the scope of the term "person" should be remedied to ensure that regulatory requirements do not inadvertently constrain firms' use of the defense. Financial services companies may include multiple lines of business and complex organizational structures imposed for legal/regulatory considerations, but leverage technological and financial infrastructure across the entire organization.

Therefore, we propose the following:

"The defense under this section may be asserted by a person who performed or caused the performance on its behalf of the acts necessary to establish the defense. Such person may license such defense only to (i) an entity that controls, is controlled by, or is under common control with that person so long as such entity became affiliated with such person in good faith for reasons other than receiving such license, or (ii) an entity providing services to such person or licensed affiliate, solely to the extent such services are provided on behalf of such person or licensed affiliate."

Importantly, the revised language keeps the same "good faith" requirements of the current provision thereby ensuring that one company cannot "buy the defense" by purchasing another company simply to gain access to the defense for itself.

The defense enables an earlier inventor to continue doing what it was doing before an asserted patent was filed, but problematically does not free the earlier inventor to make even obvious modifications to its business practices. In particular, the defense applies only to "subject matter that would otherwise infringe one or more claims... [of] a patent being asserted against a person, if such person had, acting in good faith, actually reduced the subject matter to practice at least one year before the effective filing date of such patent, and commercially used the subject matter before the effective filing date of such patent." The problem is that if the prior inventor had created and commercially used subject matter that was almost the same as that covered by the patent, but was not identical, then the earlier inventor would not be able to use the defense. This would be the case even where the patented invention was abundantly obvious given the subject matter created by the earlier inventor. Such a result technologically freezes the earlier inventor and prevents it from using obvious variations of its earlier business practices. This does not logically make sense.

We support revising section 273 to essentially incorporate the obviousness standard of 35 USC § 103 in determining the scope of an earlier inventor defense under section 273. In particular, the defense would be available to an earlier inventor if the patent claim "would be invalid under section 102 or 103 of this title if such subject matter is deemed to be prior art." We believe such an amendment reflects a balanced approach that protects patent owners and enables earlier inventors to continue to use both what they had previously commercially used (i.e., subject matter that has been "actually reduced to practice and commercially used, or substantial preparations for commercial use have been made, before the effective filing date of such patent") as well as all that would have been obvious there from.

## **Willfulness (Section 5)**



We support the language in S. 1145 on willfulness because it provides a critical clarification to the damages rules related to the all-too-prevalent imposition of treble damages when willfulness is found. In our view, the bill strikes the right balance to punish copyists, but encourage good faith due diligence and investigation – certainly a desirable practice for an industry new to patents.

In patent law, infringement can be found even if there is no intent on the part of the defendant to infringe. However, the current status of the law has set the bar so low for notice that claims of willful infringement are standard in infringement complaints and defendants can be heavily penalized for vague and non-specific knowledge of the patent.

Some patent holders take advantage of this uncertainty by blanketing an industry with vague letters that offer a license or make outright accusations of infringement. These letters often do not list which products or services that the patent may apply to and in some cases do not even list the patent numbers relevant to the situation. A recipient of this type of letter must scramble to try to determine not only which of the potentially hundreds of products, services and processes the letter implicates, but also every possible interpretation of the claims a patentee may have. Even if a recipient does the investigation and returns with a theory of non-infringement, the patent holder can just shift the focus of the inquiry, starting the process all over again. These investigations are time consuming and expensive, requiring outside counsel opinions, and escalate other business costs such as delayed product launches.

Aside from the high cost of investigation, the low notice requirements have encouraged a head in the sand attitude for many businesses. Instead of doing patent studies for new product launches, some businesses worry that mere inquiry to the existence of a patent will trigger a notice provision, and therefore do not study the existing patents in the relevant fields. Some worry whether reading articles about issued patents trigger the notice provision. None of these situations promotes a healthy patent system, and none were the intended consequences of the concept of willfulness that sought to single out the worst infringers.

A codified standard with fair and meaningful notice provisions would restore the balance to the system, reserving the treble penalty to those who were truly intentional in their willfulness and end the unfair treble damage windfalls for mere knowledge of a patent. As such, the financial services industry strongly supports the notice requirements set forth in (b)(2)(A).

Indeed, the FSR and SIFMA have jointly filed amicus briefs at the invitation of the Federal Circuit arguing that the current jurisprudence is out of balance and exactly backwards --imposing an affirmative duty on the defendant and creating liability risk for mere knowledge of another's patent. This chills the ability to even undertake an investigation of a competitor's or third party's patent position.

To combat the problem, SIFMA created and operates a clearinghouse (see, [http://apps.sifma.org/IP\\_Warehouse/](http://apps.sifma.org/IP_Warehouse/)) to connect interested parties on predatory patent assertions and licensing. Nevertheless, registered members face the additional risk of triggering notice and potentially an affirmative duty to obtain an opinion of counsel under the current rule

We look forward to continued discussion with the Committee and bill sponsors on (b)(2)(B), which allows willful infringement upon a finding of intentional copying. While blatant copying of a patented product with knowledge of the patent should be grounds for willfulness, further clarification is needed to ensure that mere notice of a patent, particularly by individuals not involved in the development of the product at issue, does not constitute intentional copying. If it did, (b)(2)(B) would essentially reinstate the current low notice threshold.

### **Apportionment (Section 5)**

Apportionment reform is needed to rationalize damages awards, which are being inflated by unreasonable calculation methodologies. Complex products in our industry, for example, often rely on numerous features or processes, many of which are unpatented. Even where the patented component is insignificant as compared to many unpatented features, patentees base their damage calculations on the value of an entire end product. This standard defies common sense, distorts incentives and encourages frivolous litigation.

Justice Kennedy gave voice to this concern in his *eBay* case concurrence:

“[i]n many cases now arising . . . the nature of the patent being enforced and the economic function of the patent holder present considerations quite unlike earlier cases. 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”

Section 5(a) of the bills addresses this problem by requiring that consideration be given to “the economic value that should be attributed to patent’s specific contribution over the prior art,” and the terms of non-exclusive marketplace licensing of the invention. We look forward to continued discussion with the Committee and the bill sponsors regarding the “entire market value” rule in (a)(3) to ensure the market value is based overwhelmingly on the patent’s specific contribution over the prior art.

## Effective Date

S. 1145 is currently drafted to “take effect 12 months after the date of enactment” and applies only to patents “issued on or after that effective date.” We believe that Section 13(a) should be amended so that the provisions related to litigation take effect immediately upon enactment. The litigation provisions in Section 5 appropriately are effective immediately. The provisions in Section 10 should take effect immediately as well. Lower courts are able to handle changes in the law, whether by statute or judicial decision, quickly and seamlessly. Courts do not need 12 months to prepare for the proposed modifications Section 10.

Perhaps more importantly, the litigation provisions in this Act and the post-grant review mechanism should apply to patents issued before or after the effective date of this Act. In many instances a plaintiff will assert multiple patents in a single case, some of which may have been issued before and some after the effective date of this Act. If this Act only applies to patents granted after the effective date, courts could be forced to apply different standards of venue, interlocutory appeal, prior user defenses and damages to different patents-in-suit in the same case. This will dramatically increase the complexity and cost of the cases.

In the chart below, I have provided our views as to how the effective dates should be modified. Again, whether effective immediately or after a grace period, the laws should apply to all non-expired patents and patent applications, not just those filed after the law is enacted.

Section	Provision	Effective Immediately	Effective after Grace Period	Litigation Reform/Patent Quality
3	First to File		<input checked="" type="checkbox"/>	Patent Quality
4	Inventor's Oath		<input checked="" type="checkbox"/>	Patent Quality
6	Post Grant		<input checked="" type="checkbox"/>	Patent Quality
7	PTAB changes		<input checked="" type="checkbox"/>	Patent Quality
9	3 <sup>rd</sup> Party Submission		<input checked="" type="checkbox"/>	Patent Quality
10	Venue	<input checked="" type="checkbox"/>		Litigation Reform
10	Interlocutory Appeals	<input checked="" type="checkbox"/>		Litigation Reform
11	PTO authority	<input checked="" type="checkbox"/>		Litigation Reform

## **Clarification of Secret Prior Art**

S. 1145 departs from the previous refinements to the novelty provision (Section 102) that were set forth in the bills of the 109<sup>th</sup> Congress. The former bills generally aligned U.S. novelty standards with international patent standards by requiring prior art to be "publicly known," and publicly accessible, whereas

S. 1145 uses the language "in public use or on sale" in Section 102(a)(1). We are concerned that the proposed "in public use or on sale" language could be construed in a manner that penalizes or discourages research-and-development collaboration between companies. Courts could potentially hold that patents on prototypes, code or the like from inter-company collaboration are invalid or "on sale", despite an executed arms-length confidentiality agreement between separate companies.

In contrast, in Europe and the U.K. the existence of a confidentiality agreement provides a clear "safe harbor" for such collaboration. Under Article 54(2) of the EPC, "The state of the art shall be held to comprise everything made available to the public by means of a written description or oral description, by use, or in any other way, before the date of filing the European patent application." If we look to section 2(2) of the U.K. Patents Act of 2004, it recites that "[t]he state of the art in the case of an invention shall be taken to comprise all matter...which has at any time before the priority date of that invention been made available to the public... by written or oral description, by use or in any other way." The clear reference to "available to the public" is significant in that it supports the ability of organizations (in Europe) to protect against novelty-destruction by entering into confidentiality agreements incidental to research and development activities. For example, in Europe, a secret sale of an invention (e.g., a prototype) that is subject to a non-disclosure agreement is simply not regarded as prior art. (See, e.g., 1992 O.J.E.P.O. 646, 652.)

Under the proposed bill language, the danger exists that when "company A" contracts or collaborates with "company B" for the development, certain development activities such as building prototype, or design models resulting from that collaboration could work against the parties as to later-arising patent rights. An accused infringer under patent rights arising from the development work could argue that the development activities qualify as an invalidating secret offer for sale or sale. (*M&R Marking Systems, Inc. v. Top Stamp, Inc.*, 926 F. Supp. 466, 470-471 (D.N.J. 1996); *In Re Kollar*, 286 F.3d 1326, 1334 (Fed. Cir. 2002)). Although the patent owner may ultimately prevail on technical arguments under a vague totality of circumstances test, the presence of a binding, air-tight confidentiality agreement is not decisive of the outcome under the totality of the circumstances test. (See, e.g., *Netscape Communications Corporation v. Konrad*, 295 F.3d 1315 (Fed. Cir. 2002).) This could be an expensive and time consuming loophole that infringement defendants could attack to require patent holders

to successfully defend their patent validity, based on an activity- i.e. open innovation and research and development cooperation -- which should otherwise be encouraged. This problem, in our view, would place U.S.-based firms at a disadvantage vis-à-vis global competition.

For these reasons we recommend the following changes to the novelty provision: (1) in Section 102(1)(a), replace "public use or on sale" with "otherwise publicly known" or "otherwise available to the public." The above change to the H.R. 1908/S.1145 will allow organizations to contractually protect against unintentional invalidity of patents by executing a binding non-disclosure agreement with collaborating organizations.

## **Conclusion**

It is time for Congress to act. The litigation around patents is too fervent and the awards and settlements too unbalanced. The Supreme Court of the United States has recognized and written eloquently against abuses, but the Court's recent decisions do not obviate the need for legislation. On the contrary, they suggest a clear need for legislative action.

We support S. 1145 as essential to increase patent quality and restore some balance and fairness to the litigation landscape. We encourage members of the Committee to work with the bill sponsors to report the bill to the full Senate this month so that the Senate can act during this session.

Thank you for the opportunity to testify.