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Panel on Developing Business Models: View From the Industry

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I appreciate the opportunity to participate in today's hearings. I want to thank the FTC for its leadership in focusing attention on the need to make our patent system more effective in fulfilling the mandate to "promote the progress of science and the useful arts."

Cisco has a keen interest in innovation and in the important incentives the patent system provides to innovate. Our inventions are at the center of the internet's role as a ubiquitous worldwide communication medium. Cisco invests more than five billion dollars annually in R&D. We have more than 5,000 issued US patents and more than 5,000 pending. Our patent portfolio is consistently ranked as number one in the telecommunications space by the Patent Board. We innovate both through internal R&D and by acquiring companies -- 130 by last count -- most of which are start-ups that complement and enhance our business and internal innovation.

We follow changes in the intellectual property marketplace closely, and we are very concerned by recent developments. Increasingly, activity in this marketplace is not driven by increased innovation, but by efforts to exploit imbalances in a patent system that overvalues patents, particularly weak ones, and thereby actually suppresses marketplace innovation.

In preparation for these hearings, I reviewed the FTC's 2003 report which recognized the potential harm to innovation from a surge in licensing demands. Warning about the proliferation of patents, the Commission noted that innovators and manufacturers "may have to choose between the risk of being sued for infringement after they sink costs into invention or production, or dropping innovative or productive efforts altogether. Either option can injure economic welfare."[1]

That is precisely what has become the reality today. Patent laws created to promote innovation are being used to drain funds from innovators, harming our economy. We have seen an almost irrational exuberance in business models that attempt to make money solely from asserting patents against operating companies. Cisco's history as a defendant in patent infringement actions demonstrates this trend. A little over ten years ago, Cisco was sued for patent infringement for the first time. Nearly all of the cases that followed in the next few years were brought by other operating companies that made and sold competitive products and developed their inventions in-house.

What we have seen since then is a dramatic rise in the volume of cases brought directly or indirectly against Cisco, including nearly a quadrupling of pending cases in the last five years. The patent cases filed against Cisco in recent years do not involve competitors -- virtually all of the litigation activity has been with non-practicing entities with no appreciable business of making or selling products or services. In many cases, these plaintiffs are not the original assignees or inventors, and indeed are not themselves innovators. Instead, they purchased the patents in the marketplace for the sole purpose of

[1] To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy, A Report by the Federal Trade Commission, Ch. 2, p.28 (October 2003).

litigation or threat of litigation and never intended to make or sell any products or services.

In addition to these lawsuits, we also receive letters requesting that we license patents. We also see an increasing number of requests inviting Cisco to purchase patents -- at a rate of five to ten requests per week. We look at every one of these -- even the "friendly" requests that we purchase their patents rather than license them. Where relevant to our business and the seller's expectations are reasonable, we do license or purchase the patents. The vast majority of these patents however are of questionable quality and so we decline. In several cases where we have so declined, the patent holder then filed suit against us. We have other cases where the patent holder sells the patents we declined to a third party who then also immediately files suit against us.

In most instances, there is no contact or allegation of infringement until well after our products were developed and have been on the market for years. In nearly all of our cases the first time we have seen or heard of the patents is when we are served with a copy of the complaint, and no reasonable search would have flagged the patent as applicable to our products.

Even when the infringement allegations are baseless, the costs of defense are large for technology companies, ranging from three to four million dollars per case on the very low end to well over twenty five million on the high end, with five to ten million being more typical.

Some plaintiffs seek an amount just under the costs of litigation, knowing that with the uncertainty caused by imbalances in the system, a company must seriously consider resolution under such terms. Other patent holders make huge demands based on

a system that allows for jackpot-type victories – indeed we've had demands as high as over eight billion dollars. In fact, in a meeting, one plaintiff actually demanded "a gazillion dollars." Inevitably, these plaintiffs also seek treble damages for willfulness even though in most cases the patent issued years after our products were developed and the only notice we received of these patents was in the complaint or in their offer to sell or license.

Beyond the financial costs, every assertion we receive distracts our engineers from innovation. Evaluation of the patents requires a significant amount of time that would otherwise be spent developing new products, not to mention the time-consuming discovery requests, depositions, testimony and travel to far away jurisdictions.

To be clear, when a patent owner presents a legitimate claim that we are using or could use their patented invention, and their expectations are reasonable, we voluntarily and readily license or in some instances purchase the patents. In some cases, we have been the party to initiate discussions. But more often, the assertions we receive present patents of dubious validity and weak arguments of infringement, yet request amounts that are orders of magnitude beyond the fair value of the alleged use of the invention in our product.

Because of the imbalances and uncertainty in our current patent system, even when our engineers and experts tell us that the patent has nothing to do with our product or is very clearly invalid, we cannot ignore such a patent. The odds are stacked against invalidating even weak patents. One area rife with uncertainty is the calculation of reasonable royalty damages. Plaintiffs regularly seek a percentage of the total value of a product that is allegedly infringing, rather than the value of what was actually invented,

which may be related to a minor feature of the overall product. This was demonstrated by a recent jury award of over five hundred million dollars against Microsoft. Even though the only accused feature of Microsoft's Outlook program was a drop down calendar function within its date picker feature, damages were assessed as a large percentage of the entire revenues for the overall program.

With this potential downside, while one might prefer to fight these baseless assertions on principle and to deter opportunistic actors, effective risk management unfortunately forces companies to settle even questionable claims more often than is desirable. The money that is used for settlement and attorneys' fees has an adverse impact on innovation in that it directly takes away from the budget used to employ our engineers and fund R&D.

Fueling the cycle even further, an increasingly common approach for those who assert patents as a business is to accumulate new patents from each target with which they settle as part of payment, which then in turn are immediately asserted against other companies.

All of these factors conspire to raise risk levels and drive unmeritorious settlements, which in turn lead to heightened interest and investment in businesses based on the acquisition and assertion of patents by companies that do not themselves make products and services or innovate.

So why can't we simply avoid all these issues by analyzing the patent landscape before we design a product and simply design around these patents? The reason is simple -- it is impossible to achieve any degree of certainty by such "clearance searches." Beyond the sheer quantity of issued patents in our field, the current system allows patent

holders to construe claims so broadly that a reasonable product company would often never recognize most of the patents that might ultimately be asserted in speculative litigation. Even if we could identify such patents, this knowledge could lead to a later claim of willfulness, even post-*Seagate*, on a patent that was not even relevant to our product development.

The end result is the exact opposite of the patent system's purpose. Innovation is discouraged. The money to pay unjustified settlements is taken away from R&D in promising technologies for the future and added to the costs that are ultimately passed along to consumers. Most troubling perhaps is the lost opportunity for new products and services that would lead to new jobs and the bolstering of America's technological leadership. The consequences for innovation are potentially just as dire as the injury we have seen to our financial system.

We need to reform the system. The most important change we can make is to ensure that damages are based on the fair economic value of the innovation that gave rise to patentability. There has been much discussion and debate about this issue. But at the end of the day, the question is simple: What was actually invented and what value does the true innovation add to the product? To answer that question, the place to start is the value of the invention rather than the value of the overall product that includes the invention. If I invent a new tire tread, is it reasonable that I can pursue a percentage of a $25,000 car just because a tire with that particular tread is incorporated into the car? No reasonable person can accept this premise, and yet that is current practice in the high tech patent world.

As an innovator and patent holder, we are in favor of a strong patent system that rewards innovation and promotes competition. The patent marketplace will continue to exist and will in fact be strengthened by reforms to the patent system. There will always be a demand to trade patents to aggregate them and for other reasons, but the value of patents should reflect the true value of what was actually invented.

We look forward to the FTC's continued work on the patent system. There is a real opportunity to once again drive productive change. If there is a more balanced system, then expectations will be more reasonable and real patents will continue to thrive and be even more readily licensed. The result will be a robust marketplace with transparency that fairly values patents, something that is good for innovation and competition.