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To: House Judiciary Committee

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Subject: **SB 38** – Protecting Kansas Small Business Owners from Abusive Litigation and Licensing Demands with Respect to Vague Patent Infringement Claims

Chairman Barker and distinguished members of the House Judiciary Committee, thank you for the opportunity to provide testimony today on behalf of the Kansas Association of REALTORS® in support of **SB 38**, which will provide Kansas small business owners with reasonable protections against abusive threats of litigation and exorbitant requests for licensing fees with respect to vague patent infringement claims. At the same time, **SB 38** completely preserves the right of legitimate businesses and individuals to enforce and protect their patent rights in Kansas.

KAR is the state's largest professional trade association, representing nearly 8,000 members involved in both residential and commercial real estate and advocating on behalf of the state's 700,000 property owners for over 95 years. REALTORS® serve an important role in the state's economy and are dedicated to working with our elected officials to create better communities by supporting economic development, a high quality of life and providing affordable housing opportunities while protecting the rights of private property owners.

#### What is a "Patent Troll?"

Over the last few years, many academic studies, media reports and trade publications have documented a drastic increase in the amount of litigation regarding the licensing, ownership and use of patents. All the academic research that exists on this issue generally supports the concept of patent rights, which provide the inventors of new ideas or processes with an exclusive right to profit from the inventions for a certain period of time. This is obviously a powerful incentive for economic growth and future innovation.

However, patent policy must also strike a very delicate balance between protecting the inventors of patents and discouraging abusive litigation or overly broad patent claims that dampen the incentives for future innovation and increase legal and compliance costs for other businesses and individuals. Abusive litigation and overly broad patent claims can lead to a reduction in economic growth as legitimate businesses are discouraged from pursuing innovative ideas and investing in new technologies and industrial processes due to the risk of patent infringement.

From 2004 through 2012, patent lawsuits in the United States more than doubled from 2,500 cases filed each year to around 5,000 annually.<sup>1</sup> Unfortunately, the overwhelming majority of this litigation is initiated by entities that make no attempt to actually manufacture a product or provide a service that is derived from the patents covered in the patent infringement claims.

In 2012, roughly 62 percent of all patent lawsuits brought in the United States were initiated by so-called "patent assertion entities" or "patent trolls."<sup>2</sup> In contrast to businesses that actually utilize patent rights to manufacture products or provide services covered under the patent, these shell entities exist solely to acquire the rights to existing patents and to send demand letters to other businesses and individuals seeking to extract licensing revenue for alleged infringement of the acquired patents.

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<sup>1</sup> Catherine Tucker. *The Effect of Patent Litigation and Patent Assertion Entities on Entrepreneurial Activity* (June 22, 2014). <http://ssrn.com/abstract=2457611>.

<sup>2</sup> Colleen Chien. *Patent Assertion Entities*. Presentation to the DOJ/FTC Hearing on PAEs. (December 10, 2012).

These are not legitimate and productive companies that harness inventions and innovations to hire employees, produce products and services and generate economic growth for the American economy. Unfortunately, these entities have created increased legal compliance costs and extracted licensing fees from many sectors of the American economy, including banking, computer hardware, construction, electronics, hospitality, information technology, manufacturing, pharmaceuticals, real estate and retail.<sup>3</sup>

According to one study conducted by researchers at the Boston University School of Law, the entities targeted by patent trolls were forced to spend roughly \$29 billion in direct costs to mount a defense to patent infringement claims in 2011. Although large firms accrued over half of these direct costs, most of the defendants were either small or medium-sized businesses.<sup>4</sup>

Having said that, the increase in the number of lawsuits filed for patent infringement has also been accompanied by a much larger increase in the number of lawsuits that are threatened against businesses and individuals through legal demand letters issued by patent trolls. Patent trolls generally assert very broad patent claims against an unusually large set of potential defendants, which are not based on any specific evidence or studies that the actual products or services offered or technologies employed by the potential defendant infringe on the patents owned by the patent troll.

The very wide net cast by the patent troll is intended to identify businesses and individuals that will seek to settle the patent infringement claim rather than contest the claim in court through litigation. According to several studies on the issue, conservative estimates place the number of threats issued by patent trolls in the last year alone at a minimum of 60,000 and more likely at over 100,000.<sup>5</sup>

Generally, the “patent troll” business model combines many of the following characteristics: (1) they do not utilize the patents to develop or research any products, services or technologies related to the patents; (2) they acquire patents solely for the purpose of extracting payments from alleged infringers; (3) they acquire patents whose claim boundaries are unclear and then (with little specific evidence of infringement) ask a large number of entities at once for licensing fees; and (4) they hide their identities by creating numerous shell companies and requiring those who settle to sign non-disclosure agreements.<sup>6</sup>

#### MPHJ Technology Investments: A Case Study in the Patent Troll Business Model

As an example, the prime case study of the patent troll business model is an entity known as “MPHJ Technology Investments,” which has been established as a limited liability corporation in the state of Delaware. In conjunction with over a thousand subsidiaries with an alphabet soup of various acronyms and names, MPHJ claims to own a group of patents that cover any office networking system that uses a scanner, network and computer to scan documents and email them to other computers on the network.

MPHJ does not claim to be a technology company and, as far as anyone has been able to ascertain, the company has no employees and the company’s only physical presence is a post office box in Delaware. In reality, a Federal Trade Commission investigation has determined that MPHJ’s owner and sole employee is a trial attorney who resides in Texas. The sole purpose of the company and its related subsidiaries is to send demand letters to small businesses that have between 50 and 100 employees and demand a licensing fee of \$900 to \$1,200 for every employee of the business that uses a scanner to scan documents and email them to another computer using any type of email software.

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<sup>3</sup> Sara Jeruss, Robin Feldman and Joshua Walker. *The America Invents Act 500: Effects of Patent Monetization Entities on US Litigation*. 11 Duke Law and Technology Review 357 (2012).

<sup>4</sup> James Bessen & Michael Meurer, *The Direct Costs from NPE Disputes* 1 (Boston University School of Law Working Paper No. 12-34, 2012).

<sup>5</sup> Chien 2012.

<sup>6</sup> Chien 2012.

According to internal company documents obtained through a lawsuit filed by the company against the Federal Trade Commission, MPHJ and its subsidiaries sent demand letters for patent infringement to nearly 16,500 small businesses across the United States over the last three years. This process typically consists of sending a series of three or four demand letters to small businesses with between 50 and 100 employees (or affiliated independent contractors in the case of real estate brokerages).

Generally, the first demand letter is a simple demand letter that informs the business that they are suspected of employing technology that infringes on MPHJ's patents covering the scanning and emailing process. The intent of the first demand letter is to offer the allegedly infringing business a chance to purchase a license to utilize the technology for roughly \$900 to \$1,200 per employee or affiliated independent contractor.

According to the various resources on this issue, very few of the targeted businesses respond to the first demand letter. If MPHJ does not receive a response to the first demand letter, a second demand letter is normally dispatched within several months. The language in the second demand letter becomes a little more threatening and the business is again offered the chance to purchase a "license" to use the technology. Again, very few of the targeted businesses respond to the second demand letter.

Finally, MPHJ sends a third and final demand letter to each of the businesses that do not respond to the first two demand letters. Typically, this third demand letter contains much stronger and threatening language and promises to file a lawsuit against the business unless the business chooses to purchase a "license" to use the technology for its employees and affiliated independent contractors and a copy of a sample lawsuit complaint is typically attached to the third demand letter. According to the resources on this issue, roughly 40 to 50 percent of the targeted businesses respond to the third letter by either hiring legal counsel or attempting to contact MPHJ.

Obviously, the financial incentive for MPHJ to target businesses is the potential for the businesses to agree to purchase a "license" to use the technology for all of its employees and affiliated independent contractors. Since the company is known to target businesses with between 50 and 100 employees, this means that MPHJ has the potential to collect roughly \$45,000 to \$120,000 in licensing revenue from each targeted business.

If just five percent of the targeted businesses were to agree to pay a \$900 license fee and each business had the minimum amount of 50 employees or affiliated independent contractors, MPHJ would stand to receive roughly \$37 million in revenues from the effort. Assuming that a maximum of 40 percent of the profits were to be allocated to the law firms contracted to send the demand letters and pursue litigation, the net profit to the owner of MPHJ would be roughly \$22 million. This is obviously not a bad profit for a company that has no employees, no overhead and has never actually invented or produced any commercial ideas or products.

#### Practical Example from Kansas to Illustrate the Growing Problem: Real Estate Brokerage Targeted by Patent Troll

Unfortunately, this is not just some abstract national problem that has no effect on small businesses in Kansas. On a daily basis, small businesses in Kansas are systematically targeted by patent trolls with arbitrary and vague legal demand letters alleging patent infringement. As a result, these Kansas small business owners are forced to confront these threats to their livelihood by weighing the risk of potential patent infringement litigation against the exorbitant cost of paying the demanded unreasonable licensing fees to patent trolls.

In 2013, a medium-sized Kansas real estate brokerage (with around ten full-time employees and 75 affiliated real estate salespersons and associate brokers) received a threatening letter from a subsidiary of MPHJ alleging that the real estate brokerage was utilizing a scanner and computer network that infringed on a series of patents owned or licensed by the subsidiary of MPHJ. In addition to asserting that the real estate brokerage was infringing upon the entity's patents, the letter demanded that this real estate brokerage pay a roughly \$102,000 licensing fee to the MPHJ subsidiary (\$1,200 for each of the 85 users within the real estate brokerage of the allegedly "infringing" scanner and computer network).

Basically, the real estate brokerage purchased a relatively common copier/printer/scanner machine from a local small business that specializes in providing and servicing copies, printers, scanners and network systems to small businesses. Allegedly, the MPHJ subsidiary owns a patent that covers the process of scanning documents into a scanner and then emailing those documents to a recipient over a computer network. Given the standard customs and technologies employed in virtually every sector of the Kansas economy (and even the Kansas Legislature), it is safe to assume that nearly every Kansas business infringes upon this alleged patent.

Thankfully, the managing broker of this particular real estate brokerage was also a licensed attorney and had a limited amount of experience in a previous career with business, franchise and trademark issues. As a result, he undertook a thorough review of the letter and the patents that were allegedly owned by the MPHJ subsidiary and infringed upon by the scanner and computer network operated by the real estate brokerage.

In doing so, the real estate brokerage owner noted that the demand letter specifically failed to describe the exact type of scanning and computer networking systems employed by the real estate brokerage and how those systems specifically infringed upon the patents allegedly owned by the MPHJ subsidiary. As a result, the real estate brokerage owner concluded that this entity would be unlikely to prevail in any litigation for patent infringement until this specific analysis had been conducted and a detailed report was prepared specifying how the scanning and computer networking systems violated the specific patents noted in the letter.

Over the course of the next six months, the real estate brokerage owner continued to receive a series of vague demand letters threatening the real estate brokerage with litigation if the real estate brokerage did not pay the demanded licensing fees to the MPHJ subsidiary in return for the right to employ a scanning and computer networking system in the real estate brokerage. At this time, the real estate brokerage has never responded in any manner to the demand letters and no litigation has been filed against the real estate brokerage for patent infringement in this matter.

Unfortunately, the overwhelming majority of REALTORS® and small business owners do not possess a similar level of knowledge with the patent and trademark law. At this time, it is impossible to estimate the number of Kansas small business owners that have been coerced by these vague legal demand letters into paying exorbitant and unreasonable licensing fees to various MPHJ subsidiaries.

#### Federal and State Government Responses to the “Patent Troll” Problem

In response to this problem, numerous actions have been taken by Congress, state legislatures, state attorneys general and private businesses to introduce reforms to this process to protect targeted businesses from patent trolls such as MPHJ. In addition to an investigation that has been conducted by the Federal Trade Commission (FTC), members of Congress have introduced roughly 20 bills relating to patent litigation reform and numerous state attorneys general have sued various patent troll entities for violating state law.

However, the most concrete steps taken to combat the patent troll problem have so far been undertaken by state legislatures. As of August 2014, 20 states (including the state of Missouri) have enacted legislation to crack down on “bad faith patent infringement claims.”

The main focus of the state legislation has been to provide the state attorney general and private businesses with the right to bring litigation against patent trolls for “bad faith assertions of patent infringement.” This legislation seeks to balance the right of legitimate patent owners to protect their patents against infringement and a need to prevent illegitimate businesses entities from extorting and harassing small businesses over false or incomplete patent infringement claims.

## Summary of **SB 38** Regarding “Bad Faith Assertions of Patent Infringement”

**SB 38** has been modeled after similar pieces of legislation that were drafted and passed by the states of Missouri and Vermont and legislation introduced in Congress (**H.R. 3540**). Basically, the draft legislation prohibits any person from making a “bad faith assertion of patent infringement” and then specifies the factors that must be considered by a court in determining whether a person has asserted a bad faith patent infringement claim. Most importantly, the legislation does not prevent legitimate businesses and individuals from asserting a patent infringement claim in good faith.

Basically, **SB 38** completely protects the right of legitimate businesses and individuals to enforce patent infringement claims against other businesses and individuals as long as they comply with the minimally-intrusive obligations found in the legislation. Most importantly, nothing found in **SB 38** would prevent a legitimate business from protecting their patent rights by either sending a legal demand letter or bringing litigation against an infringing party.

Instead, **SB 38** simply seeks to provide protections to Kansas small business owners from the threats faced when dealing with bad faith assertions of patent infringement from patent trolls, which again are entities that are established only for the extraction of licensing fees from other businesses through the transmission of an unreasonably large number of vague legal demand letters to small businesses and individuals. Rather than limiting or destroying the right to enforce patents, **SB 38** simply establishes some simple requirements that must be met when a demand letter alleging patent infringement targets an individual or business in Kansas.

Again, nothing in **SB 38** would prohibit any business or individual from seeking to fully enforce their patent rights in Kansas. Instead, **SB 38** would simply require each demand letter alleging patent infringement to contain, at a minimum, the following information:

- (1) The name of the person asserting the patent infringement claim;
- (2) the patent number of the patent that is subject to the patent infringement claim; and
- (3) factual allegations concerning the specific areas in which the target’s products, services and technology infringe the patent or are covered by the claims in the patent.

Fundamentally, we believe that this is the minimum amount of information that each target of the demand letter will need to fully evaluate the claims of patent infringement claims contained in the demand letter and to decide whether they are not they are interested in either agreeing to pay a license for the patents in question or dispute the patent infringement claim in court. **SB 38** will simply ensure that the Kansas businesses and individuals targeted with patent infringement demand letters have all the necessary information to completely evaluate the patent infringement claims contained in the demand letters.

If a demand letter does not contain all of this required information or if the entity sending the demand letter does not comply to any requests for the information required under the legislation, then **SB 38** creates a civil violation of bad faith assertion of patent infringement. In addition, **SB 38** would provide either a private party facing a bad faith assertion of patent infringement or the Kansas Attorney General with the right to seek injunctive relief or pursue damages in civil court against patent trolls that do not comply with the act.

## Conclusion

In closing, we would respectfully request that the members of the House Judiciary Committee support **SB 38** to provide Kansas small business owners with relief from patent trolls and bad faith assertions of patent infringement. Kansas REALTORS® strongly believe that **SB 38** strikes the proper balance between protecting the right of legitimate businesses and inventors to protect their patent rights and protecting small business owners from frivolous litigation and exorbitant patent licensing expenses.

Earlier this session, **SB 38** passed the Senate on a vote of 40 to 0. Thank you for the opportunity to provide comments on this very important issue for Kansas small business owners.