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"The U.S. Intellectual Property System and the Impact of Litigation Financed by Third-Party Investors and Foreign Entities"

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When lawyers fund their own cases, they do so with an understanding that they owe their clients a duty of loyalty. That is, lawyers are supposed to respect the wishes of their clients as those wishes evolve throughout a lawsuit. We have a system in America in which lawyers need to make money, but they also need to help their clients achieve justice. Sometimes justice in a given case includes money awards, like compensatory damages, or even punitive damages when necessary to deter bad conduct. And often lawyers get paid a percentage of the money award their clients receive. When lawyers fund their own cases, they do so with one eye on their ability to recover their costs and make a profit, and the other eye on achieving what their clients view as a just result.

But what happens when lawyers enter into agreements with third parties to fund their lawsuits under a fiduciary duty to maximize not justice, but their own profits, using contracts that condition funding on the lawyer and their client's losing some degree of control over the case to their financial backers? Lawyers aren't supposed to sign away their clients' autonomy in cases to some third party whose financial interests may diverge at one point or another with how the client wants to handle their case. But that's what lawyers are increasingly doing.

Unlike most lawyers, third party litigation financers *only* want to make a profit. That's the sole reason they exist: to make money for themselves and their investors. Unlike law firms, third party litigation financers don't have a privileged, fiduciary relationship with the plaintiff, even as they may be pulling the strings in a lawsuit.

Now, one might ask, aren't third party litigation funders just private businesses that should be allowed to operate in a free market? No. Third party litigation funders are *not* purely private businesses in the sense that their entire business model is based on leveraging the *power of government* through lawsuits.[1] Here's how.

In the United States, attorneys who file lawsuits can, by simply filing a complaint at their unfettered discretion, immediately subject defendants to the threat of a default judgment (a judgment for the plaintiff entered after the defendant fails to timely answer or otherwise appear). That threat of a default judgment, *which is enforced by the government*, forces defendants to spend money and resources toward their defense in order to avoid the default judgment. That dynamic results in a situation in which a defendant will be made to pay any amount to the plaintiff in settlement, provided the settlement demanded is less than the defendant's costs of defense and the plaintiff's attorneys' costs for filing the case (which are minimal).[2] As legal and economic professors have described the situation under current law:

> [T]he plaintiff may choose to file a claim at some (presumably small) cost. If the defendant does not then settle with the plaintiff and does not, at a cost, defend himself, the plaintiff will prevail by default judgment ... Given the model and the assumption that each party acts in his financial interest and realizes the other will do the same, it is easy to see how nuisance suits can arise. By filing a claim, any plaintiff, and thus the plaintiff with a weak case, places the defendant in a position where he will be held liable for the full judgment demanded unless he defends himself. Hence, the defendant should be willing to pay a positive amount in settlement to the plaintiff with a weak case ...[3]

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[1] *See generally* Paul Taylor, *The Difference Between Filing Lawsuits and Selling Widgets: The Lost Understanding that Some Attorneys' Exercise of State Power is Subject to Appropriate Regulation*, 4 Pierce L. Rev. 45 (2005).

[2] The Federal Rules of Civil Procedure, for example, place no limits on the ability or authority of a lawyer to file a complaint. *See* Fed. R. Civ. P. 11 (a civil action is commenced by filing a complaint with the court). Once a complaint is filed, the court clerk sends a summons to the plaintiff or their attorney, who then serves the summons and a copy of the complaint on the defendant. *See* Fed. R. Civ. P. 4. The summons carries with it the threat of a default judgment if the defendant does not respond, thereby requiring a response, however innocent the defendant might be.

[3] David. Rosenberg and Steven Shavell, *A Model in which Suits are Brought for their Nuisance Value*, 5 Intl. Rev. L. & Econ. 3, 3 (1985). These commentators point out that defendants face a form of extortion because "to defeat a claim, the defendant will have to engage in actions that are frequently more expensive than the plaintiff's cost of making the claim, for the defendant will have to gather evidence supporting his contention that he was not legally responsible for harm done to the plaintiff or that no harm was actually done." *Id*. at 10. As another commentator has pointed out: "The state could require the attorney to submit for ex parte approval a proposed defendants list that includes constitutional rationales for naming each defendant. But the courts and legislatures have delegated these decisions to attorneys. By allowing discretion into procedural rules, the state grants decisional power to attorneys. These grants of discretion substitute the attorney's decisions for those of a judge or other state officer or body." James W. Harper, *Attorneys As State Actors: A State Action Model and Argument for Holding SLAPP-Plaintiffs' Attorneys Liable Under 42 U.S.C. § 1983*, 21 Hastings Const. L.Q. 405, 423-24 (1994).

In essence, in America, I could pay a small filing fee, hand you a complaint making a ridiculous claim against you, and say, "This case would cost you $10,000 to defend yourself and win, but you'd be out that money. Why don't you just pay me $7,000 now, I'll give a cut to my funders, and then I'll go away, and that way, you'll save $3,000 out of the $10,000 it would have cost you to litigate this case to victory."

The key point here is that that sort of legal extortion relies on the government's power to enforce the default judgment. No truly private business, relying solely on voluntary agreements in a free market, could rely on government power to its advantage in that way. But third party litigation funders can and do. The Supreme Court itself has noted this institutionally coercive role lawyers are allowed to play in society, stating:

> As an officer of the court, a member of the bar enjoys singular powers that others do not possess; by virtue of admission, members of the bar share a kind of monopoly granted only to lawyers ... [A]s an officer of the court, a lawyer can cause persons to drop their private affairs and be called as witnesses in court, and for depositions and other pretrial processes that, while subject to the ultimate control of the court, may be conducted outside courtrooms. The license granted by the court requires members of the bar to conduct themselves in a manner compatible with the role of courts in the administration of justice.[4]

But one might ask, don't people have a remedy when they're the victim of frivolous lawsuits in America? No. Federal Rule 11 fails to provide an effective remedy. The current federal rule (Rule 11 of the Federal Rules of Civil Procedure) allows judges to deny the victims of frivolous lawsuits any compensation for the harm they suffered, even when the judge determines the lawsuit against them was *legally frivolous*. That's because judges aren't required to order that the victim of a frivolous lawsuit's costs be paid back.[5] As a result, the current Rule 11 goes largely unenforced, because the victims of frivolous lawsuits have little incentive to pursue additional litigation to have the case declared frivolous when there is no guarantee of compensation (even when the judge agrees the case is frivolous).

That's why third party litigation financing is so attractive in America. Because America lacks a "loser pays rule" (a rule that provides that if you file a frivolous lawsuit against someone, you'll have to compensate them for the money they spent defending themselves), our justice system can be gamed to extort money from innocent people. Because third party litigation funders operate solely for profit, it is their *fiduciary duty* to turn the justice system into a purely profit-making enterprise for themselves. That's not what lawyers are supposed to do. Again, when a lawyer leverages government power in the way I've described, she does so with one eye on her own compensation, and the other eye on justice as understood by her client. But the third party litigation financer has both eyes fixed solely on the money, and it leverages government power solely to that end. Third party litigation financing breaches the attorney's duty of loyalty

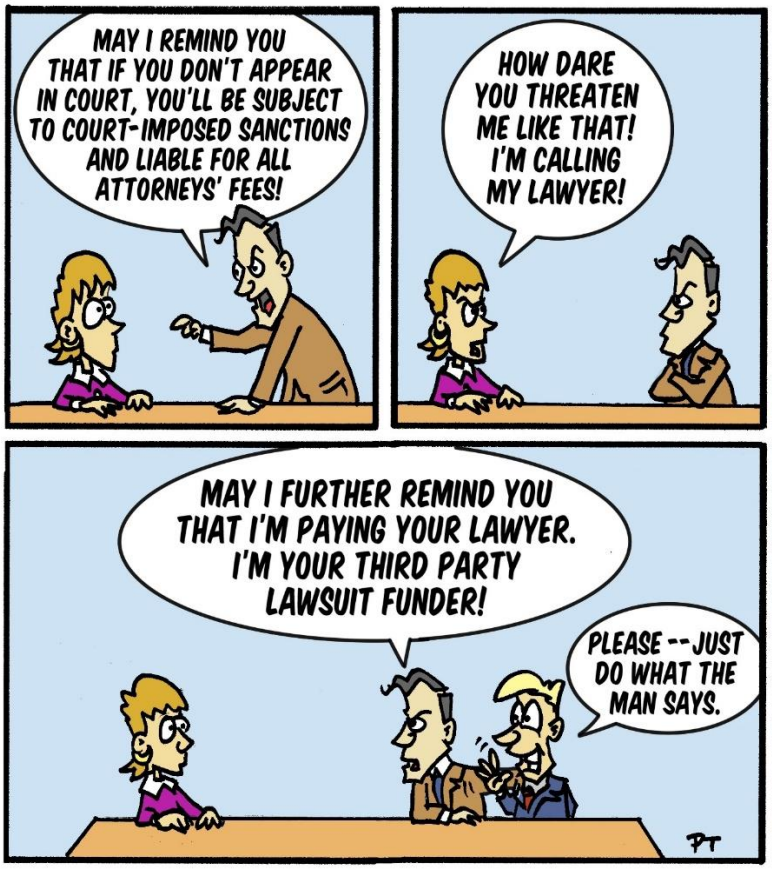
[4] *In re Snyder*, 472 U.S. 634, 644 (1985).

[5] Rule 11 of the Federal Rules of Civil Procedure does not require any sanctions at all for the filing of frivolous lawsuits. *See* Fed. R. Civ. P. 11(c) ("the court *may* … impose an appropriate sanction ….") (emphasis added). Rule 11 uses the term "may," not "shall."

by placing profit in the eyes of the funders and investors in place of justice in the eyes of the client.

Although the terms of litigation funding agreements are rarely disclosed, in 2023 the *Wall Street Journal* article reported on a lawsuit alleging price fixing brought by the food distribution company Sysco against beef and pork suppliers. It was revealed that Sysco got $140 million for its lawsuit from the litigation funding company Burford Capital. During the course of the lawsuit, Sysco decided it wanted to settle with the defendants, but Burford objected. As it turns out, the financing agreement between Sysco and Burford stipulated that Sysco "shall not accept a settlement offer without [the funder's] prior written consent, which shall not be unreasonably withheld." The funder maintained that Sysco was settling for too little. Burford's chief investment officer even wrote an email stating "We are going to have to sue them it seems. They are about to breach our contract." Lawyers' clients, not litigation funders, are supposed to retain the autonomy to decide how their own cases are handled. But that's not what happened in this case. Unfortunately, today, it takes lawsuits like Sysco's to pull back a curtain that hides conflicts of interest that violate core principles of legal ethics.[6]

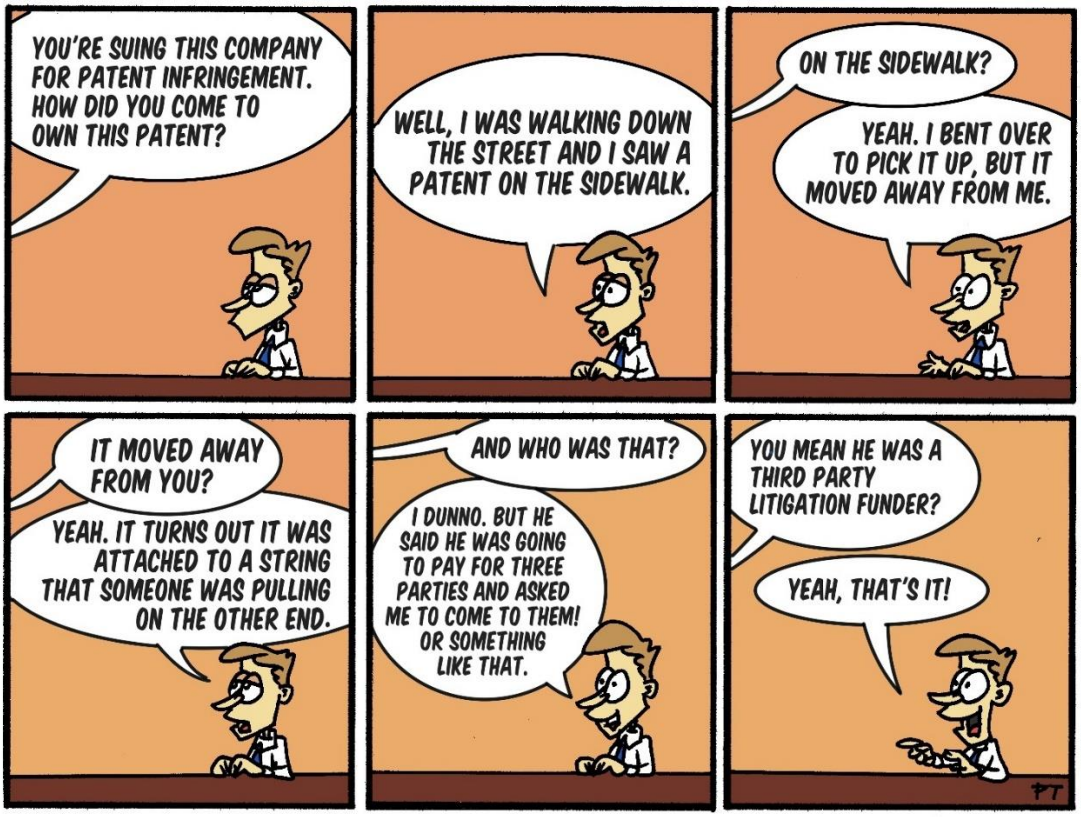
[6] While working for the House Judiciary Committee, I handled legislation aimed in part at requiring greater disclosure of third-party litigation financing contracts, so more of these tensions could be exposed. The committee report associated with that legislation noted an agreement for third-party funding of a class action lawsuit, *Gbarabe v. Chevron Corporation*, involving an oil rig explosion off the Nigerian coast which refers to a "Project Plan" for the litigation developed by the funder, "with restrictions on the ability of the class action lawyer to deviate from it." In that case, Judge Susan Illston of the Northern District of California ordered the disclosure of the third-party litigation funding agreement because the



Supporters of third party litigation financing often portray the funders as helping David versus Goliath. But in fact the funders themselves can be the Goliaths exploiting the Davids. In November, 2023, Chief Judge Colm Connolly of the District of Delaware issued an opinion that referred people associated with the patent litigation funding firm called IP Edge to their state disciplinary bars, the Texas Supreme Court's Unauthorized Practice of Law Committee, the U.S. Patent and Trademark Office, and the Department of Justice for their conduct in directing several people, including a food truck owner and a surgical assistant, to agree to assume LLC liabilities associated with patent litigation in his federal court without disclosing the interests of IP Edge, which stood to gain 90% of the gross lawsuit recovery from the patents in question. That was followed by the release of text messages, internal documents, and private communications demonstrating, as Judge Connolly described it, an "obvious disparity in the sophistication of the LLC plaintiffs as opposed to … IP Edge." In one exchange between one of the LLC owners and an employee of IP Edge, the small business owner explains she doesn't feel comfortable testifying in federal court (because she's unfamiliar with the patent and the shell company structure the litigation funders set her up with), texting that "I have nightmares almost every night thinking about it and so stressed." While the patent owners were promised only 5-10% of the proceeds of the patent infringement suit, they accepted all the liability. Keep in mind that this scheme was only revealed after Judge Connolly had issued a transparency order, which

"funding agreement is relevant to the adequacy [of representation] determination and should be produced to [the] defendant."

suggests these situations may be much more common. This sort of situation is akin to predatory lending practices like payday lending, where customers might be exploited because they're desperate and relatively unsophisticated.[7]



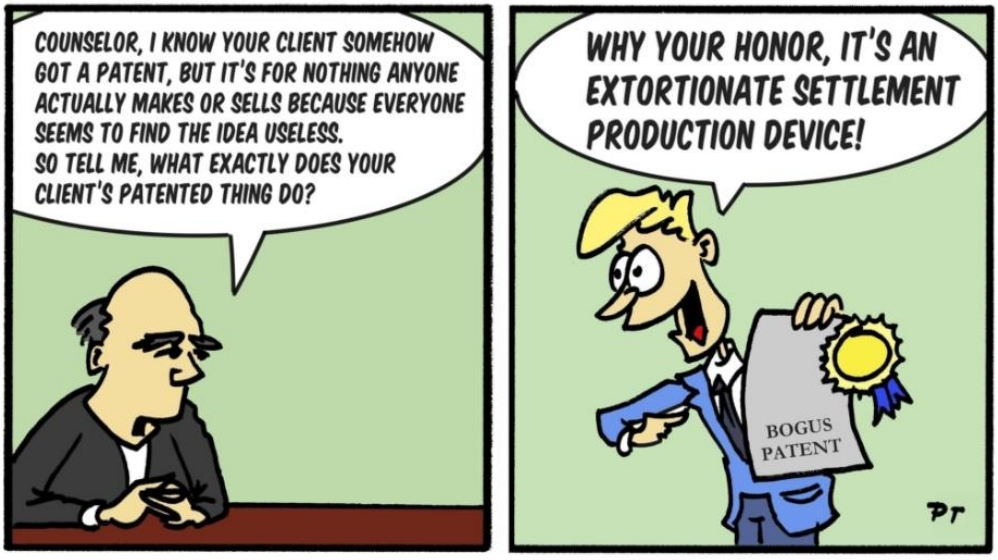
Congress has previously been so concerned with these sorts of practices that it enacted the Truth In Lending Act,[8] a federal law created to help ensure consumers are treated fairly by businesses in the lending market and informed of the true costs of their agreements.

[7] *See generally* Paige Marta Skiba & Jean Xiao, *Consumer Litigation Funding: Just Another Form of Payday Lending?*, 80 Law & Contemp. Probs. 117 (2017).
[8] 15 U.S.C. 1601.

Now, you might ask, allowing all these dysfunctions constitutes terrible public policy, but why are we having this hearing in a subcommittee that deals with patent law? It's because third party litigation funders are particularly attracted to patent litigation in America. Beyond the background dysfunctions of the American legal system generally, with its lack of a loser pays rule, the patent litigation system includes additional dysfunctions that third party financers can leverage to increase their profits. Here's how that works.

In patent litigation, funders work with so-called "patent trolls" – companies that often don't make any products themselves, but instead seek out and buy up old, low-quality patents that likely shouldn't have been granted in the first place. These trolls, and their funders, then use these patents to threaten companies that actually develop and sell products people want with infringement lawsuits, in the hopes of exploiting the dysfunctions in the American legal system described previously to extort money from productive American companies.

In patent litigation, this extortionist effect is even stronger because patents, once granted by the Patent and Trademark Office (including patents that were not properly granted under the relevant rules), are legally deemed to have a "presumption of validity." The Patent Act establishes that once a patent has been granted by the Patent Office, "a patent shall be presumed valid"[9] and "the burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting such invalidity."[10] The Court of Appeals for the Federal Circuit, which hears patent suit appeals, has interpreted this provision to require a party defending against an infringement charge to do so by "clear and convincing evidence" that a patent was improperly granted,[11] which is a *much higher standard* than the usual "preponderance of the evidence." That gives people who bring infringement claims an unfair advantage over people who claim the patent at issue was improperly granted in the first place.



[9] 35 U.S.C. § 282.
[10] *Id*.
[11] *Pfizer, Inc. v. Apotex, Inc.*, 480 F.3d 1348, 1359 (Fed. Cir. 2007).

That evidentiary imbalance incentivizes jurors without technical backgrounds to find for patent troll plaintiffs following the route of least resistance. Think about it. Today, a typical patent trial, involving a host of complex issues, will only last a couple weeks, and much of the trial will have to involve educating the jury about the relevant technology, the patented invention, the product or method that is accused of infringement, and any prior art that allegedly invalidates the patent. Just imagine having to serve on a jury and decide all those issues as well as the technical details of a case involving, for example, a "quantum interference device, comprising: a light emitting element; and an atomic cell on which light from the light emitting element is incident, wherein the atomic cell accommodates alkali metal atoms therein ..." Confused jurors in cases involving complicated technical issues involving patent infringement claims will find it much easier to find for the patent troll, *simply because doing so requires meeting a much lower evidentiary standard*, especially when the jury's verdict must be unanimous. If jurors are confused about a technical patent issue, they'll find it difficult to reach any decision, but since they would have to reach much further to get to "clear and convincing evidence" (allowing the defendant to prevail) they'll have the incentive to "tap out" at the much lower "preponderance of the evidence" standard (and decide in favor of the patent troll). Under those circumstances, it's easy to see why even innocent innovators have to settle lawsuits -- and in doing so, settle for an injustice.[12]

In this regard, it's important to understand that the Founders (not just those who crafted our Constitution, but also those who crafted our original patent statutes) emphatically *opposed* anything like a presumption of validity for patents. They recognized that patents encourage innovation and private enterprise, but also that some patents are granted improperly. They saw improperly-granted patents as a particularly bad problem because patents are government-granted monopolies that give patent holders the exclusive right to profit from the patented product for a certain time. It follows that a patent that was improperly granted unfairly denies others the right to sell something they should be allowed to sell, making the improperly-granted patent an unjust monopoly. The Founders despised unjust monopolies, and they strove to make sure the victims of unjust patent monopolies could seek easy relief. America derives its patent law from England where, in the sixteenth century, and like many governmental powers, patent grants fell into abuse. As patent historian Bruce Bugbee has written, "In the last twenty years of the [sixteenth] century the [English] Queen's habit of dispensing monopolies became notorious … Public outcry arose over such monopolies."[13] By the time of the American Revolution, anti-monopoly sentiments were part of the popular culture. Indeed, the Boston Tea Party of 1773 itself was a protest over the exclusive control the British East India Company exercised over tea under its royal grant of monopoly. James Madison, the Father of the Constitution, remained a consistent critic of monopolies, writing, "Monopolies tho' in certain cases useful, ought to be granted with caution, and guarded with strictness agst. abuse." He noted the need for patents, but

[12] *See generally* Paul Taylor, *Disclosing High Roller Bankrolling in the Patent Litigation Casino: The Need to Regulate Third Party Litigation Financing*, 103 J. Pat. & Trademark Off. Soc'y 21 (2023). Not to mention that third party litigation financers can also impose vastly disproportionate discovery costs on innocent defendants. The infringement phase of a patent case includes reams of allegations and document production requests regarding the defendant's products, whereas patent trolls produce nothing with their patents and have no products to answer questions about.

[13] Bruce Bugbee, Genesis of American Patent and Copyright Law 36 (1967).

only those that embody "benefit actually gained to the community," as otherwise they "may produce more evil than good." Improperly-granted patents for things that don't meet the criteria for legitimate innovations constitute unjust monopolies, and when the government enforces an illegitimate patent, the government itself is denying others the right to innovate in areas in which they would otherwise be able to do so freely.

With these understandings in mind, the first Congress was keenly aware of the need to allow easy challenges to improperly-granted patents. Section 5 of the first Patent Act of 1790 allowed challenges to the validity of a patent, with the patent enjoying no presumption of validity whatsoever. The Act allowed challengers to prevail upon showing "sufficient" evidence, and even provided that successful patent challengers would have their legal costs repaid. And when the modern patent examination system was created in the Patent Act of 1836, the Senate committee report on that legislation clearly recognized that, while the Act would create a new examination system, any such system would be fallible and inevitably grant improper patents on occasion. The Senate report noted that even diligent patents examiners would work under circumstances that would lead to the granting of invalid patents, warranting an easy system of review:

> It is obvious that the power [of granting patents] must, in the first instance, be exercised by the department charged with this branch of the public service. But as it may not be thought proper to entrust its final exercise to the department, it is deemed advisable to provide for an occasional tribunal to which an appeal may be taken. And as a further security against any possible injustice, it is thought proper to give the applicant in certain cases, where there may be an adverse party to contest his right, an opportunity to have the decision revised in a court of law.
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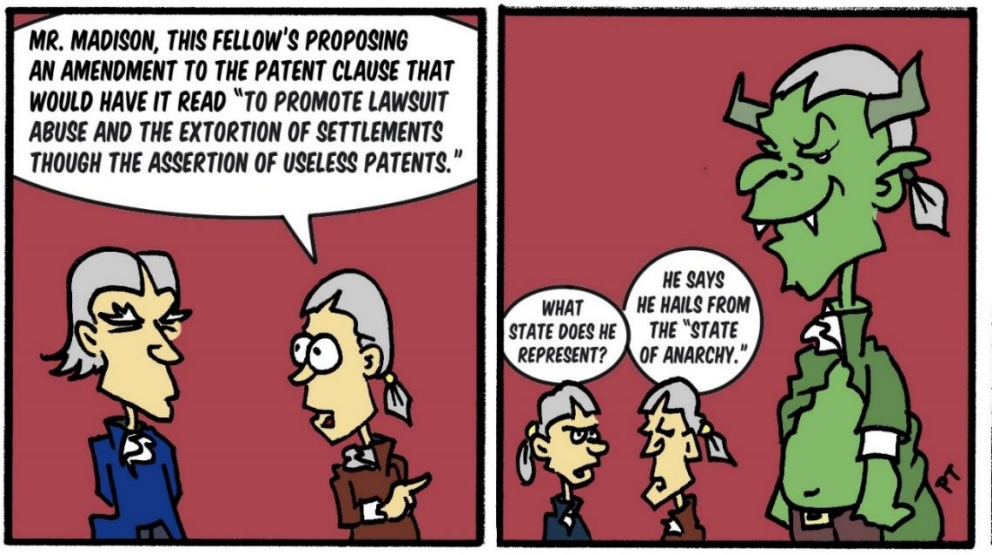
> And under the Patent Act of 1836, *no presumption of validity was granted to patents.*[14]

[14] *See generally* Paul Taylor, *Anti-Monopoly and Pro-Commerce: The Original Frontier Spirit of American Patent Law and Its Implications for Today*, 74 Syracuse L. Rev. 59 (2024). The Supreme Court in 1853 summarized the evidentiary change made by the Patent Act of 1836, and read the Act as reinstating the standard that patents would be considered mere "prima facie" evidence of validity, stating "The patent act of 1790 had made a patent *prima facie* evidence," and that under the Patent Act of 1836 "a patent may be and generally is received as prima facie evidence of the truth of the facts asserted in it." *Corning v. Burden*, 56 U.S. (15 How.) 251, 270-271 (1853) (emphasis added). As a result, even under the Patent Act of 1836, which reinstituted an examination system, a patent was still only "prima facie" evidence of validity, a much lower standard for invalidating a patent than the "clear and convincing" evidence standard required today. Black's Law Dictionary, for example, defines "prima facie evidence" as "Evidence that will establish a fact or sustain a judgment *unless contradictory evidence is produced*," and cites C.J.S. Evidence, §§ 226, 729, 1300-1305, 1320, 1324, 1326-1327, 1342, 1345 for the proposition that "prima facie evidence … merely declares that certain conduct shall suffice as evidence until the opponent produces contrary evidence." Black's Law Dictionary (8th edition, Bryan Garner, ed. 2004) ("prima facie evidence") (emphasis added)). Westlaw's "Practical Law" Glossary states that "A prima facie standard of proof is relatively low. It is far less demanding than the preponderance of the evidence, clear and convincing evidence and beyond a reasonable doubt standards that are also commonly used." Westlaw "Practical Law" Glossary ("prima facie").

But today, third party litigation financers and the patent trolls they fund can exploit an unfair and unwarranted "presumption of validity."



And patent trolls and their funders can take the form of *foreign enemies*, who can extort money through our legal system not for profits' sake alone, but as a means of siphoning resources away from American industries, including defense industries. As the Federal Trade Commission reported under the Obama Administration, patent trolls "can deter innovation by raising costs and risks without making a technological contribution."[15] And researchers have found that "[patent troll] litigation has a real negative impact on innovation at targeted firms: firms substantially reduce their innovative activity after settling with [patent trolls]."[16] Other researchers examined how patent troll litigation affected the field of healthcare information technology in light of litigation over medical imaging software patents. As those researchers concluded:

> No new variations of existing products or new models of imaging software were released by the affected vendors during the period of litigation. An explanation for this lack of innovation is that the vendors did not want to run the risk of being found guilty of "willful infringement" in the patent suit and being liable for treble damages. Therefore, one explanation of the slow-down in sales is that the product release and attendant sales cycle was halted as a result of litigation. This emphasizes that even if patent-assertion entities [patent trolls] do not prevail in the courtroom, their actions can have significantly negative consequences for incremental innovation while litigation is ongoing.[17]

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[15] Federal Trade Commission, The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition (2011).

[16] Lauren Cohen, Umit G. Gurun, and Scott Duke Kominers, Empirical Evidence on the Behavior and Impact of Patent Trolls, in Patent Assertion Entities and Competition Policy (D. Daniel Sokol, ed., 2017) (Abstract).

[17] Catherine E. Tucker, *Patent Trolls and Technology Diffusion: The Case of Medical Imaging*, SSRN (April 14, 2014) at 4.

We know that foreign enemies such as China can use third party litigation financing to disrupt American industries important to our national defense. We know that foreign enemies such as China have the will to exploit any and all means of disrupting American business and our economy generally. We just don't know the extent of it, because we don't have a uniform rule requiring the disclosure of third party litigation financing contracts when money damages are at issue. But we need to know the extent of it before it's too late. As former Secretary of Defense Donald Rumsfeld said, "there are known unknowns — that is to say, we know there are some things we do not know," and the issue of third party litigation financing by foreign enemies is a known unknown of a most dangerous kind.

Before the terrorist attacks of 9/11, there were several known unknowns that intelligence agencies and policymakers faced. Intelligence agencies were aware of the general threat posed by terrorist groups like al-Qaeda but didn't have specific details about the planned attacks. They knew that terrorists intended to strike the United States but lacked concrete information on their timing, targets, and methods. Agencies knew of al-Qaeda's existence and its intent to harm America, but the specifics of its operational capabilities and the identities and activities of its members weren't fully known. In the same way, we know foreign enemies want to harm America any way they can, and that they can use third party litigation financing to do so now. But we don't know the details or the extent of such activities because there's no uniform rule requiring the disclosure of third party litigation financing agreements.

We can go a long of way toward solving the problem of known unknowns with the simplest policy imaginable: transparency. And we know this works through the efforts of federal Chief Judge Connolly of the District of Delaware. A few years ago, Chief Judge Connolly, who handles a lot of patent cases, began to get the impression that the lawyers in cases before him often seemed unable to give him straight answers to questions, as though they needed to check with someone else first. Consequently, he issued standing orders in April, 2022, mandating the disclosure of any third party litigation financing contracts that applied to any party in his courtroom. As he explained in a November, 2022, memorandum, this was an attempt to address potential "abuse of our courts." And his simple disclosure requirements have had dramatic results. Third party litigation financing companies have already sought to *dismiss their own funded cases* in Judge Connolly's court simply because they don't want to reveal their financing arrangements. As has been reported, "The Fortress Investment-backed company spent three and a half years litigating patent infringement claims against Intel in Delaware, but elected to walk away as Chief Judge Colm Connolly insisted on more disclosure into its ownership structure. VLSI … agreed with Intel on Tuesday to a stipulated dismissal of its Delaware claims, rather than submit to further inquiry from Connolly into VLSI's ownership structure."

Let that sink in for a moment. Judge Connolly's simple act of requiring that these arrangements be made public caused the funders of the lawsuit to dismiss the cases they were funding for years.

But Judge Connolly is just one judge, and his disclosure rule only applies in Delaware. In the meantime, as has been reported, patent troll litigation in the U.S. is "up by 24% in the first quarter of 2024, with the bulk of those cases filed in the Eastern District of Texas after developments in … the District of Delaware … reduced their appeal for such plaintiffs."

I've illustrated some of the points I make in this written testimony with cartoons (it's a hobby of mine), but the situation is serious. The bad news is that today, we face the perfect storm of legal and international dysfunctions. Our legal system that rewards meritless lawsuits meets third party financers who see the justice system solely as a profit source. Those financers find maximum leverage of these dysfunctions in the American patent litigation system, and use that leverage to extract profits through the legal extortion of productive American companies that have done nothing wrong, but instead have provided Americans with the products and national defenses that serve them best. And foreign enemies can now freely fund that extortion, and in doing so not only weaken American businesses and defenses, but also use those ill-gotten gains to fund other anti-American plans of their own.

The good news is that Congress can help dispel this perfect storm by simply exposing third party litigation funding agreements to the light of day.