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Before the
Senate Committee on Small Business & Entrepreneurship
"An Examination of Changes to the U.S. Patent System and
Impacts on America's Small Businesses"
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Chairman Vitter, Ranking Member Shaheen, and Committee Members, I am grateful for the opportunity to be here today, and to offer these remarks.

I. Background

I am the Chairman-Elect of the Licensing Executives Society (USA and Canada), Inc. (LES). LES is a non-profit, non-partisan professional society devoted to bringing the fruits of innovation rapidly to market for the benefit of the global community. Founded over 50 years ago, LES is a diverse community of over 3,000 business executives, lawyers, and consultants engaged in the orderly transfer of intellectual property rights in all industries, from life sciences to high technology, and from enterprises large and small, as well as academia and government labs. LES is engaged in education, identification of best practices, career development, and networking. The Society recognizes the important role that effective and reliable intellectual property protection regimes play in the growth of economies and improvements in the human condition. LES is a founding member society of the Licensing Executives Society International, Inc. (LESI), which has a worldwide membership of over 10,000 members in 32 regional societies in over 90 countries. Licensing today is a global enterprise.

I am a registered patent attorney, practicing intellectual property law for 30 years. I am a shareholder, and head of the Life Sciences Practice of the multinational intellectual property law firm RatnerPrestia, PC. The views expressed here are those of LES, and are not necessarily those of each of its members, nor do they represent the views of RatnerPrestia, or any of its clients.

II. Introduction

We are here today to discuss how recent changes to our intellectual property protection regime in general, and our patent system in particular, affect small business. The effects are profound. The work of this Committee could not be more important, nor this topic more timely. I thank you for addressing this issue. The U.S. small business community needs your help.

III. Our Patent System – Goals and Objectives

Our patent system is the great equalizer. It levels the playing field. Properly balanced, it enables the nimble innovator, regardless of size or resources, to disrupt entrenched markets and bring forth new ideas,

products, and services. And we, the public, are the beneficiaries. James Madison said of the patent and copyright clause of the Constitution[1] that the "utility of this power will scarcely be questioned," and that the public good fully coincides with the claims of individual authors and inventors.[2]

It is important to bear in mind that when we talk of the patent system, we are talking of a property right. The Framers were influenced by the philosopher John Locke, who held that title to property resides in those who labor to bring it forth; it does not derive of the "fancy or covetousness of the quarrelsome and contentious," who "ought not meddle with what was already improved by another's labor."[3]

Lately, our public discourse has been driven by the quarrelsome and contentious. Those who would derogate ancient principles of property upon which this country was built, and deprive inventors of their exclusive right. Here is where this Committee can do its best work. The aptitude and penchant for invention runs deep in the American spirit, and is reflected both in the manner and degree to which we reward it. This Committee fulfills a noble purpose, firmly aligned with both the public interest and the innovator: to safeguard the labor of the industrious, who struggle against odds to bring new ideas and products to market to improve the human condition.

The exclusive patent right plays a laudatory role in specialization. By making innovation a tradeable commodity, small innovators need not perform all steps necessary to bring an invention to market. They can license their invention, and go back to the lab with the funds needed for more research.[4]

In addition to allowing inventors to do what they do best—invent—patents are critical to the financial success of any startup. According to a study recently conducted for the USPTO by faculty members at Harvard and New York University business schools, a startup's first patent grant increases its likelihood of receiving venture capital funding by 2.3 percent—53 percent higher than a startup without a patent.[5] The authors found that this effect was strongest for startups that (1) had raised little capital before receiving a patent; (2) were founded by inexperienced entrepreneurs; (3) are located in areas where attracting investment is harder; and (4) operated in the IT sector.[6] Ultimately, patent "alleviate investors'

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[1] U.S. Constitution, Article I, Section 8, clause 8: "The Congress shall have Power To...promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries...."

[2] Madison, J., Federalist No. 43 (1788) ("The utility of this power will scarcely be questioned. The copy right of authors has been solemnly adjudged in Great Britain to be a right at common law. The right to useful inventions, seems with equal reason to belong to the inventors. The public good fully coincides in both cases with the claims of individuals.").

[3] Locke, J., The Works of John Locke, Book II (God gave the world to men in common; but since he gave it them for their benefit, and the greatest conveniences of life they were capable to draw from it, it cannot be supposed he meant it should always remain common and uncultivated. He gave it to the use of the industrious and rational, (and labour was to be his title to it;) not to the fancy or covetousness of the quarrelsome and contentious. He that had as good left for his improvement, as was already taken up, needed not complain, ought not to meddle with what was already improved by another's labour: if he did, it is plain he desired the benefit of another's pains, which he had no right to, and not the ground which God had given him in common with others to labour on, and whereof there was as good left, as that already possessed, and more than he knew what to do with, or his industry could reach to.").

[4] *See,* U.S. Federal Trade Commission, "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy", October 2003, Chapter 2, p. 6 (footnotes omitted).

[5] *See* Farre-Mensa, J., Deepak Hedge, & Alexander Ljungqvist, *The Bright Side of Patents*, USPTO Office of the Chief Economist, Working Paper No. 2015-2 (Jan. 2016), at 3.

[6] *Id.*

concerns regarding a startup's ability to monetize its invention" and help them "signal their quality to investors"[7]—increasing their likelihood of success.

But despite the good work of this Committee, our innovators and entrepreneurs are under attack. The vagaries of economic cycles are beyond our control. But, we must remember that with economic uncertainty comes lower tolerance for risk, and reduced investment, which changes the calculus for the entrepreneur. Coincident with the global economic downturn, the death rate of U.S. start-ups surpassed the birth rate for the first time in 40 years. Uncertainty disproportionately harms small businesses and entrepreneurs. And because startups are responsible for over 20 percent of gross job creation in the United States[8] the implications are profound.

In addition, changes to the "prevailing corporate ethos" may have a profound effect on startups and entrepreneurs. Modern companies and financial institutions are increasingly seeking to maximize short-term shareholder value, rather than make long-term investments. The "financialization" of the economy disfavors long-term investments in research and development that result in greater innovations, albeit without the short-term payoff.[9] Patents provide an asset for investors to back, and a more reliable promise of return on investment.

IV. Institutional Challenges to a Reliable Patent Regime

What we can, and should, address are institutional challenges. Regrettably, our institutional approach to patents has only further challenged small business and diminished innovation. Those challenges come from changes to our patent law in the America Invents Act (AIA), and precedent that has compromised the exclusive nature of the patent right (*eBay*[10]), and rewritten the law of patent eligible subject matter (*Alice*[11] and *Mayo*[12]*/Myriad*[13]). Perhaps most significantly, pending legislation (S. 1137 and H.R. 9), if enacted, will further curtail the patentee's ability to enjoy the rights granted and to seek just reward for infringement. On top of all this is profound uncertainty as the US Patent and Trademark Office (PTO) struggles to keep up with these changes.

One recent study looked specifically at the effect of the *eBay* decision on the durability of the exclusive right. The authors looked at all patent cases filed in U.S. district courts 2000-2012, and in which injunctive relief was requested.[14] Despite the Supreme Court's explicit admonishment against an interpretation to find "expansive principles suggesting that injunctive relief could not issue in a broad swath of cases"[15], the authors found a dramatic decline in both requests for, and the grant of, injunctive

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[7] *Id.* at 5.
[8] Elisabeth Jacobs, *What Do Trends in Economic Inequality Imply for Innovation and Entrepreneurship? A Framework for Future Research and Policy*, Washington Center for Equitable Growth (Feb. 2016), at 11.
[9] *Id.* at 21.
[10] *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).
[11] *Alice Corp. v. CLS Bank Int'l*, 134 S.Ct. 2347 (2014).
[12] *Mayo v. Prometheus Labs, Inc.*, 132 S.Ct. 1289 (2012).
[13] *Ass'n for Molecular Pathology v Myriad Genetics, Inc.*, 133 S.Ct. 2107 (2013).
[14] Gupta, Kirti and Kesan, Jay P., Studying the Impact of *eBay* on Injunctive Relief in Patent Cases (July 10, 2015). Available at SSRN: http://ssrn.com/abstract=2629399.
[15] *Id.* at 1 (citing Jones, Miranda, "Permanent Injunction, A Remedy by Any Other Name is Patently Not the Same: How *eBay v. MercExchange* Affects the Patent Right of Non-Practicing Entities." Geo. Mason L. Rev. 14 (2006): 1035.).

relief, particularly preliminary relief.[16] If the exclusive right conferred in those terms by the U.S. Constitution does not, in fact, afford one the right to exclude others, then what, exactly, is the right being granted?

The FTC acknowledges the importance of the right to exclude:

> Economists recognize that without patent protection, "innovators [that produce intellectual property] cannot appropriate the full benefits of their innovation; some of the benefits go to 'free riders' without payment." If innovators know that they cannot exclude imitators and appropriate the fruits of their R&D efforts, then they may lack sufficient incentives to undertake the innovation in the first place. The problem is especially acute when the original innovator's efforts entail substantial fixed costs, and the imitators can copy the innovation cheaply. Patent rights mitigate this problem by granting exclusive rights in innovations, enhancing appropriability. Economic theory suggests that by conferring such rights to exclude, the patent system increases incentives to innovate.[17]

The inability of any enterprise, especially a smaller enterprise, to reliably secure injunctive relief encourages the free-rider or, in the parlance of the standards essential world, "reverse hold-up", or "hold-out." That is, the accused infringer refuses to negotiate a license or a settlement, recognizing that the patentee's position is compromised relative to the infringer because an injunction is unlikely. This, in turn, has given rise to the phenomena of the "efficient infringer", *i.e.*, the unscrupulous copyist who gambles infringement on the bet that the patentee will get no more than a reasonable royalty, and no injunction. If left unchecked, this phenomena will lead our patent system toward a *de facto* compulsory licensing regime, and the Framers of the U.S. *Constitution* and John Locke will roll over in their graves.

V. Challenges to Innovation

Amidst these institutional challenges, a number of reports show cause for concern over a decline in basic research, R&D funding, business formation, and job creation in the US, generally.

A. Reductions in R&D

In sounding a warning over a decline in funding for basic research, the National Science Board found:

> **U.S. Basic Research: A Need for Serious National Attention**
>
> U.S. industry and the Federal Government are the primary pillars of financial support for the U.S. research and development (R&D) enterprise. The National Science Board (Board) observes with concern the indicators of stagnation, and even decline in some

[16] *Id.* at 12.

[17] U.S. Federal Trade Commission, "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy", October 2003, Chap. 2, p. 4 (footnotes omitted); *see also, id.* at fn. 29 (noting remarks from panelists at hearings that: "in the raising of capital, the marginal importance of patent grows as the size of business declines"; that "smaller firms acquire patents to protect innovative technologies and 'hopefully put them on a somewhat level playing field with larger competitors'"; and "patents are important to small new firms without reliable internal cash flow").

> discipline areas, in support for U.S. R&D, and especially basic research, by these two essential patrons and participants. A decline in publications by industry authors in peer reviewed journals suggests a de-emphasis by U.S. industry on expanding the foundations of basic scientific knowledge. More specifically, research contributions by U.S. industry authors in the physical and biomedical sciences through publications in peer reviewed journals have decreased substantially over the last decade. In addition, in this century the industry share of support for basic research in universities and colleges, the primary performers of U.S. basic research, has also been declining. Likewise, Federal Government support for academic R&D began falling in 2005 for the first time in a quarter century, while Federal and industry support for their own basic research has stagnated over the last several years. These trends are especially alarming in light of the growing importance of knowledge-based industries in the global economy.
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> The confluence of these indicators raises important questions about implications for the future of U.S. competitiveness in international markets and for the future existence of highly skilled jobs at home. The net economic and workforce effects on the Nation and on industry of these negative changes are complex, and the Board finds that requisite data for an adequate analysis of current conditions and future trends do not presently exist. Nevertheless, the Nation must be acutely aware of the current trends as future resource allocations for basic research are debated and decided in industry and by the Federal Government.[18]

Such reports identify trends, and the trends are not necessarily attributable solely to patent policy, nor are they conclusive as to the overall and long term effect on US R&D, innovation, or the small business and start-up ecosystem. But, the NSF highlights this decline in support for research (in both the private sector and in academia) as alarming, and in need of reversal. Other reports show that new business formation is in decline[19],, and R&D investment relative to GDP in the US is likewise in decline. This is coming at a time when foreign economies are quite deliberately strengthening, not weakening, their IP regimes.

B. Declines in Start-Ups and Commercial Activity

At the same time, small business formation, growth, and survival is in crisis. According to the U.S. Census Bureau, the global economic downturn had a profound effect on the start-up economy in the U.S. Since the downturn, the death rate of small businesses has exceeded the birth rate.

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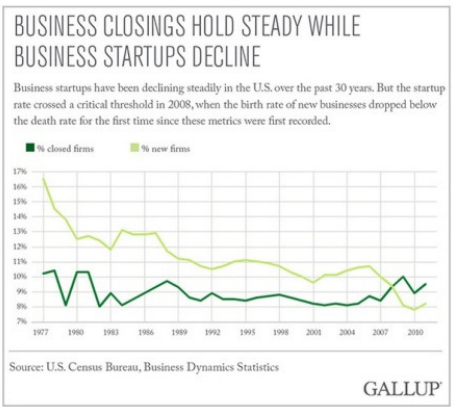
[18] National Science Foundation, "Research and Development: Essential Foundation for U.S. Competitiveness in a Global Economy", Arlington, VA (NSB 08-03), January 2008 (citations omitted) (also at http://www.nsf.gov/statistics/nsb0803/start.htm?CFID=18888052&CFTOKEN=41708777&jsessionid=f03035a792d16dcba6df3621150b7c2113f2).

[19] *See* Jacobs, *supra* note 8, at 14; Decker, Ryan et al, *The Role of Entrepreneurship in US Job Creation and Economic Dynamism*, J. of Econ. Perspectives, vol. 28, No. 3 (Summer 2014): 3-24, at 15.



This Committee knows well the strong correlation between entrepreneurial activity and the health of the economy generally, and the innovation ecosystem in particular. The implications of this trend are thus self-evident and sobering.

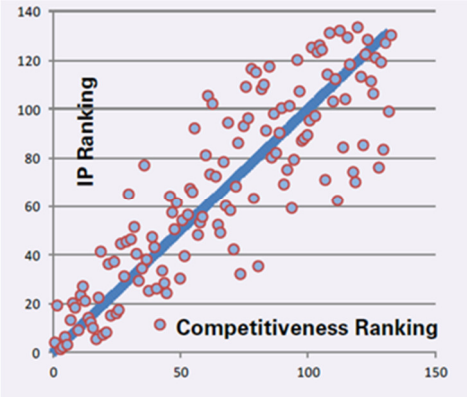
C. Income Inequality

Another challenge to the innovation economy today is income inequality. Children born in families in the top 1 percent of U.S. income are *ten times* more likely to obtain a patent at some point in their life than children born in families below the median.[20] This gap is almost entirely explained by educational disparities[21], but the implications are profound: by excluding lower-income children from our most high-quality universities, we risk cutting them out of the innovation process entirely. This is not just an appeal for general equality—it's an economic imperative. At a time when the United States' most valuable export is intellectual property—our knowledge and ideas—we cannot gamble our nation's leadership in global innovation on the accident of birth.

VI. Advanced Economies Are Dependent on Innovation and Entrepreneurial Activity

The World Economic Forum (WEF) notes that the strength of IP regimes is a reliable corollary of economic growth and competitiveness[22]:

[20] Jacobs, *supra* note 8, at 16.
[21] *Id.*
[22] World Economic Forum, Global Competitiveness Report (2009 – 2010).



The WEF paradigm involves assessing an economy for the 12 pillars of competitiveness:

> The determinants of competitiveness are many and complex. Economist have long tried to understand what determines the wealth of nations. This attempt has ranged from Adam Smith's focus on specialization and the division of labor to neoclassical economists' emphasis on investment in physical capital and infrastructure and, more recently, to interest in other mechanisms such as education and training, technological progress (whether created within the country or adopted from abroad), macroeconomic stability, good governance, the rule of law, transparent and well-functioning institutions, firm sophistication, demand conditions, market size, and many others. Each of these conjectures rests on solid theoretical foundations.[23]

A later version of that report, in noting the importance of institutions and reliable legal regimes, states:

> Ample empirical evidence has shown the importance of institutions for productivity, suggesting that their fundamental role consists in setting the right incentives and lowering uncertainty so that citizens can be confident in engaging in economic activities. Economic agents will invest only if they believe that they will reap expected benefits and returns on their work or investment without needing to spend excessive amounts of time and money protecting their property and monitoring the fulfillment of other's contractual obligations. This depends, informally, on adequate levels of trust in society; it also depends, formally, on the existence of institutions capable of ensuring a basic level of security and enforcing property rights. This in turn relies on the institutions' political set-up and power structure characterized by (1) the incidence of transparency, (2) efficiency of the public sector, and (3) the existence of checks and balances.
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> Economic literature has documented the importance of enforceable property rights for the economy — that is, the right of control over an asset and the returns it may generate provides incentives to invest (in physical or human capital or technology), create, innovate, trade, and maintain. If physical or financial property cannot be acquired and

[23] WEF, Global Competitiveness Report (2009-2010), p. 4.

> sold with confidence that the authorities will endorse the transaction over the long run, economic growth will be undermined. An absence of property rights also drives people out of formal markets into the informal sector. De Soto suggests that no nation can have a strong market economy without adequate participation in a framework that enforces legal ownership of property and records economic activity, because they are the prerequisites to obtaining credit, selling properties, and seeking legal remedies to conflicts in court. Ensuring the protection of property rights is therefore a key role of the state.[24]

The FTC acknowledges the important and laudatory role the exclusive patent right plays in Adam Smith's specialization, and how it benefits our economy in facilitating commercialization of inventions:

> Rendering innovation a tradeable [*sic*]commodity also helps foster specialization. A small firm that has invented something need not do alone all the things necessary – from the advertising and warranties to sales and service – to bring the invention to market. Instead it can license or sell its invention to another firm, which can then do whatever tasks are needed to develop and market the invention. In these ways, the patent system facilitates the commercialization of inventions. [25]

This is the lynchpin of the innovation ecosystem, and demonstrates the value of IP as a commodity and the importance of licensing. Through the orderly transfer of reliable intellectual property rights, we bring the efficiencies of market specialization to bear. Market segmentation and specialization enable enterprises most suited to their respective roles to share responsibilities to move innovative products and services from R&D, to manufacturing, to sales and distribution, and ultimately, to the end user in the market. Without that expedient, innovation will be diminished, and product development and commercialization delayed.

VII. Complications Wrought by the AIA

The AIA, though well-intentioned, has proven catastrophic for innovators and entrepreneurs. Infringers now have two bites at the apple, and a lawsuit is merely a prelude to a post-grant proceeding in the PTO. Indeed, 87% of post-grant proceedings at the Patent Trial and Appeal Board (PTAB) involve patents already in litigation.[26] The reasoning is simple, at the PTAB the challenger has a lower burden for invalidating a patent. Litigation is commonly stayed during PTAB proceedings, and, even if the challenger is unsuccessful before the PTAB, the court case will resume and the accused infringer has yet another opportunity to persuade the fact-finder that the patent is invalid.

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[24] WEF Global Competitiveness Report (2015-2016), p. 45.

[25] U.S. Federal Trade Commission, "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy", October 2003, Chap. 2, p. 6 (footnotes omitted); *see also* U.S. Dep't Justice and Federal Trade Commission, "Antitrust Enforcement and Intellectual Property Rights, Promoting Innovation and Competition", April 2007, p. 4 ("intellectual property licensing is generally procompetitive because it allows firms to combine intellectual property rights with other complementary factors of production such as manufacturing and production facilities and workforces."

[26] Vishnubhakat, Saurabh, Rai, Arti K., and Kesan, Jay P., Strategic Decision Making in Dual PTAB and District Court Proceedings (February 10, 2016). Berkeley Technology Law Journal, Forthcoming. Available at SSRN: http://ssrn.com/abstract=2731002.

The result is an enormous advantage for the well-entrenched or market-dominant player – it gets to re-open and participate in prosecution of the patent; and, it can play out the clock with serial proceedings, dramatically increasing the financial burden on the patentee. The little guy doesn't stand a chance.

The AIA has undermined confidence in the validity of patents, and calls into question their commercial value. The decline in commercial value is reflected in an overall decline in patent enforcement, and in valuations that are near a 20-year low.[27] Amid this uncertainty, businesses are increasingly turning to trade secrets. Holding an invention in secret deprives the public of the disclosure that is the *quid pro quo* for the patent grant. It drives innovation underground, and suggests a return to ancient guilds. Patent literature is often the best resource for leading edge technological information.[28] If inventors do not avail themselves of the patent system, disclosure declines, and the common store of knowledge suffers.

As the knowledge-based economy grows in importance, we should be striving for increased, not decreased, reliance on the patent system. This can only be achieved by sustaining a solid and reliable property right in exchange for disclosure.

VIII. The Dangers of Pending Legislation

Pending legislation has the potential to strike at the heart of American exceptionalism in innovation. Amidst all the uncertainty of the past seven years – economic, legal, and institutional – now comes legislation that would make it still more difficult for innovators to protect and preserve the intellectual property they brought into being. At a time when most other advanced economies are following our historic trend of strengthening patent regimes, we are reversing course and weakening our own.

This could not come at a worse time. We are still debating and interpreting the AIA; and we are deciphering precedent redefining patentable subject matter, and whether the exclusive right is, in fact, exclusive.

Now is not the time to increase confusion as to what rights the patent holder actually possesses. And it is certainly not the time to further compromise what is often the principal asset of the small business or entrepreneur.

Both S. 1137 and H.R. 9 are said to be structured to address sharp practices in patent litigation. However, both presume that patentees generally are acting in bad faith, and impose upon them burdens not found in the rightful enforcement of other property rights. Why prejudice inventors?

Those bills are now unnecessary. The supposed remedial measures they would enact have been implemented by other means. The Judicial Conference has brought the pleading requirements for patent cases in line with other civil causes of action; and has revised the Federal Rules of Civil Procedure to restrict the scope of discovery consistent with the stakes of the litigation. Recent Supreme Court precedent has substantially relaxed the standard under which judges may award attorney fees for bad faith

[27] PWC, 2015 Patent Litigation Study (May 2015) (valuations as measured by damages awards in litigation).
[28] U.S. Federal Trade Commission, "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy", October 2003, Chap. 2, p. 6, fn. 45.

patent enforcement.[29] As expected, this has increased the incidence of fee awards, and even the most pro-patent courts have lately granted substantial attorney fee awards for bad faith patent enforcement.[30]

IX. The Promise of Industry Self-Regulation

Even amidst the salutary effects of shoring up pleading and discovery in patent cases, and greater judicial discretion in awarding fees, abuses will remain. Recognizing this, LES has instituted a standards initiative whereby those engaged in IP transactions will collectively establish best practices and standards of ethical behavior in licensing.[31] LES will establish these standards through an open and inclusive process consistent with the protocols of the American National Standards Institute (ANSI), and will be modeled on the widely followed International Standards Organization (ISO) body of standards. LES will draw upon the expertise of the entire innovation ecosystem to develop standards that work in all industries, for the fully integrated manufacturer and for those that pursue more specialized revenue models, for those engaged in finance and consulting, and anyone else interested in getting the fruits of innovation more rapidly, more efficiently, and more ethically to market.

The LES Standards Initiative will preserve the incentive to innovate, harness the creativity of small business, and ameliorate the effects of bad faith patent enforcement. As such, we believe that industry self-regulation will be a more efficient and focused approach than will the blunt instrument of still more patent legislation.

I thank you for this opportunity to appear here today, and to share these thoughts with you.

I would be happy to answer any questions the Committee or its members might have, now or in the future at boshaughnessy@ratnerprestia.com or at 202-808-7365.

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[29] *Octane Fitness, LLC v. Icon Health & Fitness, Inc*., 134 S. Ct. 1749 (2014), and *Highmark Inc. v. Allcare Health Management System, Inc.*, 134 S. Ct. 1744 (2014).
[30] *eDekka LLC v. 3Balls.com, Inc.* (E.D. TX, Dec. 17, 2015).
[31] WEF Global Competitiveness Report (2009-2010), p. 4 (recognizing the economic advantages of private sector transparency, and development of standards: "An economy is well served by businesses that are run honestly, where managers abide by strong ethical practices in their dealings with the government, other firms, and the public. Private-sector transparency is indispensable to business, and can be brought about through the use of standards as well as auditing and accounting practices that ensure access to information in a timely manner.").