

# High Technology Entrepreneurs and the Patent System: Results of the 2008 Berkeley Patent Survey

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**Abstract:**

We offer description and analysis of the 2008 Berkeley Patent Survey, summarizing the responses of 1,332 U.S.-based technology startups in the biotechnology, medical device, IT hardware, software, and Internet sectors. We discover that holding patents is more widespread among technology startups than has been previously reported, but that the patterns and drivers of holding patents are industry and context specific. Surprisingly, startup executives report in general that patents are providing relatively weak incentives for core activities in the innovation process. Our analysis uncovers that the drivers of startup patenting are often associated with capturing competitive advantage, and the associated goals of preventing technology copying, securing financing, and enhancing reputation—although again these and other motives depend on firm and industry factors. We also find substantial differences in the roles played by patents for startups in the biotechnology and medical device sectors—where patents are more commonly used and considered important—as compared to those operating in the software and Internet fields—where they are less useful. Interestingly, venture-backed IT hardware startups tend to resemble those in health-related fields in terms of their use of and motives for patenting. We generally find a wide disparity between the patenting behavior of venture-backed technology startups and those that are not funded with venture capital. We also discover that, when choosing not to patent major innovations, startups often cite to cost considerations, although again the motives to forgo patenting differ according to firm and industry characteristics. The respondents to our survey also generally report that checking the patent literature and licensing patents from others is reasonably common, although there too results differ according to the context. Other findings are discussed.

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### I. INTRODUCTION: WHY INVESTIGATE HOW ENTREPRENEURS USE (AND ARE AFFECTED BY) THE PATENT SYSTEM

Entrepreneurs contribute significantly to economic growth in the U.S. and the global economy.<sup>1</sup> They create new organizations, new products, services, jobs, and opportunities for follow-on economic activities.<sup>2</sup> Intellectual property law is an important policy lever that affects not only the opportunities for engaging in entrepreneurship, but also the success or failure of many entrepreneurial efforts.<sup>3</sup>

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<sup>1</sup> See JOSEPH A. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE* 74-94 (1934) (examining the role that entrepreneurship plays in the dynamism of capitalist economies); DAVID B. AUDRETSCH ET AL., *ENTREPRENEURSHIP AND ECONOMIC GROWTH* (2006) (examining the relationship between entrepreneurship and economic growth); M.A. Carree et al., *The Impact of Entrepreneurship on Economic Growth*, in *HANDBOOK OF ENTREPRENEURSHIP RESEARCH* 437, 471 (examining the relationship between entrepreneurship and economic growth); ZOLTAN ACS & DAVID AUDRETSCH, *INNOVATION AND SMALL FIRMS* 19-24 (1990); ANDRÉ VAN STEL, *EMPIRICAL ANALYSIS OF ENTREPRENEURSHIP AND ECONOMIC GROWTH* (Springer, International Studies in Entrepreneurship Vol. 13, 2006) (examining the relationship between entrepreneurship and economic growth); Samuel Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 *RAND J. ECON.* 674, 682 (2000); J.C. Bound et al., *Who Does R&D and Who Patents*, in *PATENTS AND PRODUCTIVITY* (Zvi Griliches ed., 1984).

<sup>2</sup> See *supra* note 1; see generally Roy Thurik & Sander Wennekers & Ingrid Verheul & David Audretsch, *An Eclectic Theory of Entrepreneurship: Policies, Institutions and Culture* (EIM Business and Policy Research, Scales Research Reports H200012, EIM Business and Policy Research, Apr. 2001).

<sup>3</sup> See David Hsu & Rosemarie Ziedonis, *Patents as Quality Signals for Entrepreneurial Ventures* (Apr. 2007) (unpublished manuscript, on file with Mack Ctr. for Technological Innovation working paper series), available at [http://elsa.berkeley.edu/~bhall/e222spring07\\_files/HsuZiedonis07\\_PatentSignaling\\_abstables.pdf](http://elsa.berkeley.edu/~bhall/e222spring07_files/HsuZiedonis07_PatentSignaling_abstables.pdf) (finding that a doubling in the patent stock of venture-backed semiconductor companies leads to a 24% premium in market valuation); see also Andreas Panagopoulos & In-Uck Park, *Patent Protection, Takeovers, and Startup Innovation: A Dynamic*

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Classical economic theory holds that investments in technology development—of which entrepreneurial activities are an integral part—will be suboptimal if too little intellectual property protection exists.<sup>4</sup> However, because entrepreneurial activity may be redirected or halted by intellectual property (IP) rights claimed by others, an equally serious impediment to investment for entrepreneurs may arise if intellectual property protection is too strong or uncertain.<sup>5</sup>

Although a considerable body of previous work has explored the relationship between IP rights and innovation, far less scholarship has focused on the more particular relationship between IP rights and entrepreneurship. The basic economic principle underlying IP rights is that the process of developing innovative products and practices is an expensive, time-consuming, labor-intensive, and risky endeavor.<sup>6</sup> Once these innovations exist, however, they can be cheap and easy to copy.<sup>7</sup> IP rights protect innovators from copying by “free riders” and allow them to recoup the investment incurred during the creation, development, and commercialization process—either directly by manufacturing and distributing products and services embodying the innovation or indirectly through licensing to other firms who incorporate the innovation

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*Approach* (Centre for Market and Public Organisation Working Paper No. 08/201, May 2008), available at [http://www.epip.eu/conferences/epip03/papers/Panagopoulos\\_ip-aug08v2-sw.pdf](http://www.epip.eu/conferences/epip03/papers/Panagopoulos_ip-aug08v2-sw.pdf) (providing an economic model wherein “positive but not excessive IP protection” leads to increased acquisitions of startup firms by incumbents, thereby increasing overall innovation); Ted Sichelman, *Commercializing Patents*, 62 STAN. L. REV. \_\_ (forthcoming 2009) (exploring the relationship between patent protection and the successful commercialization of invention).

<sup>4</sup> See Kenneth Arrow, *Economic Welfare and the Allocation of Resources for Innovation*, in THE RATE AND DIRECTION OF INVENTIVE ACTIVITY (1962); WILLIAM D. NORDHAUS, INVENTION, GROWTH, AND WELFARE: A THEORETICAL TREATMENT OF TECHNOLOGICAL CHANGE (1969).

<sup>5</sup> See Stuart J.H. Graham & Ted Sichelman, *Why Do Start-Ups Patent?*, 23 BERKELEY TECH. L.J. 1074, 1080-81 (2008) (exploring how incumbents may use patent portfolios to restrain startups from entering markets); Colleen Chien, *Of Trolls, Davids, Goliaths, and Kings: Narratives and Evidence in the Litigation of High-Tech Patents*, 87 N.C. L. REV. \_\_ (forthcoming 2009).

<sup>6</sup> See Arrow, *supra* note 4, at 609.

<sup>7</sup> See *id.*

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in their products and services.<sup>8</sup> This basic economic principle applies to entrepreneurial companies as well as to other firms in the marketplace. Moreover, because early-stage firms tend to lack the kinds of “complementary” assets—such as well-defined marketing channels, manufacturing capabilities, and access to cheap credit—that provide barriers to entry for their larger counterparts, arguably they are even more sensitive to IP rights than other firms.<sup>9</sup> Nevertheless, research and policy analysis has not adequately addressed how particular IP laws differentially affect entrepreneurial firms relative to more established ones.<sup>10</sup>

In response to this noticeable gap in knowledge, the Berkeley Center for Law and Technology (BCLT) conducted a wide-scale survey in 2008 of high technology startup firms in the United States to determine how these companies use—and are affected by—the patent system. Part of our aim in conducting the survey was to identify those aspects of the patent system that substantially encourage or hinder entrepreneurial activity, particularly in high-growth technology industries such as the computer software and hardware, Internet, medical device, and biotechnology fields.

We were also concerned with the paucity of data on the potential effects of pending patent reform measures on entrepreneurs and the entrepreneurial process more

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<sup>8</sup> Concerning these latter transactions in the markets for technology, see ASHISH ARORA, ANDREA FOSFURI & ALFONSO GAMBARELLA, *MARKETS FOR TECHNOLOGY: THE ECONOMICS OF INNOVATION AND CORPORATE STRATEGY* (2004).

<sup>9</sup> See Scott Shane, *Technological Opportunities and New Firm Creation*, 47 *MGMT. SCI.* 205, 208 (2001) (“Although established firms might also be more likely to commercialize broad patents, they are disproportionately important to independent entrepreneurs who lack complementary assets.”); see generally David J. Teece, *Profiting from Technological Innovation: Implications for Integration, Collaboration, Licensing and Public Policy*, 15 *RES. POL’Y* 285 (1986) (discussing the benefits of “complementary assets”).

<sup>10</sup> See Ted Sichelman & Stuart Graham, *Patenting by Entrepreneurs: An Empirical Study*, \_\_ *MICH. TEL. & TECH. L. REV.* \_\_ (forthcoming 2010) (reviewing most of the existing literature on patenting and entrepreneurship).

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generally. Patent reform is currently the subject of a vigorous national debate.<sup>11</sup> Recent studies by the Federal Trade Commission<sup>12</sup> and National Academy of Sciences<sup>13</sup> made specific policy recommendations that inspired this debate and led to the drafting and discussion of various legislative proposals in Congress, starting in 2005 and continuing through the current session.<sup>14</sup> There has also been a renewed interest in patent law in the Supreme Court, with the Court deciding several high-profile cases over the last several years.<sup>15</sup> Recently, the Court granted certiorari in the highly controversial case of *Bilski v. Doll*, which will address the scope of patentable subject matter for “business methods.”<sup>16</sup> *Bilski* may also have implications for the patentability of software, a subject matter, along with business methods, of critical concern to many technology startups. Last, the U.S. Patent Office has been considering dramatic changes in the way patent applications are handled.<sup>17</sup> The opinions of large corporations and the organized patent bar have been expressed very clearly in the legislative and Patent Office reform debates,<sup>18</sup> but input on

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<sup>11</sup> See, e.g., Dan L. Burk & Mark Lemley, *Don't Tailor Make Patent Act: The Key to Accommodating Competing Interests Lies in the Courts*, NAT'L L.J., May 11, 2009, at 18.

<sup>12</sup> FEDERAL TRADE COMMISSION, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY (2003), available at <http://www.ftc.gov/opa/2003/10/cpreport.htm>.

<sup>13</sup> STEPHEN A. MERRILL, RICHARD C. LEVIN, AND MARK B. MYERS, (EDS.), A PATENT SYSTEM FOR THE 21<sup>ST</sup> CENTURY (2004), available at [http://www.nap.edu/catalog.php?record\\_id=10976](http://www.nap.edu/catalog.php?record_id=10976).

<sup>14</sup> See Carl E. Gulbrandsen et al., *Patent Reform Should Not Leave Innovation Behind*, 8 J. MARSHALL REV. INTEL. PROP. L. 328 (2009) (describing various congressional bills); Kevin R. Davidson, *Retooling Patents: Current Problems, Proposed Solutions, and Economic Implications for Patent Reform*, 8 HOUS. BUS. & TAX L. J. 425 (2008) (same).

<sup>15</sup> *MedImmune, Inc., v. Genentech, Inc.*, 459 U.S. 118 (2007); *KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398 (2007); *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).

<sup>16</sup> See *Bilski v. Doll*, 545 F.3d 943 (Fed. Cir. 2008), cert. granted, \_\_\_ S. Ct. \_\_\_, 2009 WL 221232 (2009).

<sup>17</sup> See, e.g., James W. Beard, *Weeds in the Docket: Patent Continuation Reforms and Their Impact on Patent Applications in the Biotechnology Industry*, 90 J. PAT. & TRADEMARK OFF. SOC'Y 423 (2008) (describing the PTO's proposed changes to the continuation rules); *Tafas v. Doll*, 559 F.3d 1345 (Fed. Cir.) (finding that the proposed continuation rules were inconsistent with the Patent Act), *pet. for reh'g en banc pending*, Docket No. 08-1352 (2009).

<sup>18</sup> See, e.g., Brief of Amicus Curiae, the Federal Circuit Bar Association, in Support of Respondents, *Teleflex, Inc., KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398 (2007) (No. 04-1350); Brief Amicus Curiae of Computer & Communications Industry Association in Support of Petitioners, *eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006) (No. 05-130); Brief Amicus Curiae of Pharmaceutical Research and Manufacturers of America, *MedImmune, Inc., v. Genentech, Inc.*, 459 U.S. 118 (2007) (No. 05-608);

how the proposed changes to patent law and policy will specifically affect entrepreneurship has been lacking.<sup>19</sup>

In the detailed results we present below, we do not offer simple answers to the difficult unanswered questions about the patent-entrepreneurship relationship. As one important example: although we find that holding patents is more widespread among technology startups than was commonly believed, their executives report that patents provide relatively weak incentives for core activities in the innovation process, such as invention and commercialization. These results raise the question: Why would startups incur the substantial costs of patenting if they find patents do not offer particularly strong incentives to engage in invention and commercialization?

Our response to this question is nuanced and multi-faceted. Specifically, there is a large share of startup firms, especially in the software industry, that avoid the patent system altogether. Even though we find that startups appear to hold more patents than prior commentators have reported, these effects were generally due to patent-holding startups reporting higher numbers of patents and applications than noted in the Patent Office databases, primarily due to patents acquired from founders and from other sources. For many of these patent-holding firms, we find that patents play a strong role in helping them to compete in the market with their technology—although this role tends to be

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Kevin Bogardus, *Stakeholders Inch Toward Final Deal on Patent Reform, but Rifts Remain*, THE HILL (Feb. 13, 2008), <http://thehill.com/business--lobby/stakeholders-inch-toward-final-deal-on-patent-reform-but-rifts-remain-2008-02-13.html>.

<sup>19</sup> See, e.g., Joe Mullin, *Small Companies Suffering In Surge Of Infringement Suits*, THE RECORDER (San Francisco), June 4, 2009, at 3 (“When the Senate began debating patent reform in March, there was plenty of testimony from patent experts, but nothing from small entrepreneurs.”). The independent inventors have been active in the patent-reform debate, see, e.g., Rick Merritt, *Inventors' group to address patent reform*, EE TIMES (06/04/2009), available at <http://www.eetimes.com/news/latest/showArticle.jhtml?articleID=217701966>, although not all independent inventors are entrepreneurs, nor are all entrepreneurs independent inventors. As such, a unique “entrepreneurship voice” has likely been missing from the reform debates.



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much more pronounced among biotechnology and “hardware” companies (including both medical “hardware” such as surgical devices, and IT hardware, such as computers and semiconductors). Conversely, patents are much less important as a means by which software firms—the majority of which hold no patents—capture competitive advantage from their technologies. We also find that, consistent with theoretical and anecdotal accounts, another key role played by patents in technology entrepreneurship involves financing and, relatedly, successful exit, such as being acquired or going public. In an important new showing, we demonstrate that patenting may be playing a heretofore underappreciated and important role in helping startups to secure investment from various sources, including “friends and family” and commercial banks.

Because these reasons for patenting have little to do with the classical “incentives” and “free rider” stories, they are exemplary of many of the results we present in this paper. We find nuanced explanations for why technology entrepreneurs use the patent system: from the reasons they decide (or not) to file for patents on their innovations; to whether and when they examine the patent literature; to their views about the patent system as a whole. With this context in mind, in Part I, we describe the specific research questions that motivated the survey, how we selected our sample, and some key profile characteristics of our respondents. Part II discusses the patent filing characteristics of technology startups, and the reportedly weak incentives patents provide to startups to engage in innovative activity. In Part III, we offer our first set of findings that help explain why startups file for patents when they, reportedly, offer relatively weak incentives to innovate. In Part IV, we assess the varied roles played by patents in helping the startup to compete, especially as compared to other means available to the firm to

capture value from innovation. Part V provides another set of key findings, these uncovering the motivations that entrepreneurs report for filing patents on their innovations. Part VI complements that discussion by exploring the reasons why technology entrepreneurs forgo patenting. Part VII completes the analysis by examining how technology entrepreneurs respond when they face patents held by others in their competitive environment. In Part VIII, we explore our key attitudinal question in the survey, and report on the general opinion among high technology executives that the patent system is neither working particularly well nor particularly poorly for their companies and industries. Part IX offers some concluding observations.

## II. SURVEYING HIGH TECHNOLOGY ENTREPRENEURS ABOUT THEIR USE OF IP

We began our project with a set of research questions addressing a variety of topics concerning patenting and technology entrepreneurship, including the following:<sup>20</sup>

- Do startups apply for patents to protect their innovations and is this a successful strategy?
  - Do they apply for patents for other reasons, e.g., to attract investors or for cross-licensing to obtain the right to use another company's patents?
- What role do actual or potential patent rights play in decisions to invest in startups?
  - In what circumstances is strong patent protection a prerequisite to investment?
  - In what circumstances are patent rights less important than other factors?

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<sup>20</sup> We were aided in formulating our research design by insights and helpful comments during discussions with Hank Barry, John Barton, James Bessen, Tom Ciotti, Wes Cohen, John Duffy, Rebecca Eisenberg, Brad Feld, Richard Gilbert, Michael Goldberg, Josh Green, Bob Gunderson, Bronwyn Hall, Mitchell Kapor, Peter Menell, James Pooley, Walter Powell, Arti Rai, AnnaLee Saxenian, Carl Shapiro, Robert Strom, Lee Van Pelt, and David Yoffie, whom we thank.

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- How do investors and entrepreneurs assess the scope and value of their own and other firms' patent rights in the course of deciding which business opportunities to pursue or to fund?
- Once entrepreneurs have initial funding, are patent rights more important to the entrepreneur than to more established companies who can rely on manufacturing, distribution and marketing capacities, brands and other reputation qualities, and their existing customer base to protect their market position?
- What steps do startups take to avoid infringing other parties' patent rights? Are they able to acquire licenses to such rights when necessary? Is inadvertent infringement a problem?
- How often do they receive allegations of infringement and what do they do in response?
  - Are entrepreneurs affected by “patent trolls” (that is, owners of patents who pursue patent litigation as a business model)?
- How would patent reform proposals affect entrepreneurial companies?

Given the breadth of these research questions, we chose a research design that would allow us to add meaningful empirical data to these issues. Knowing that the most credible source of information about how well the patent system is working for entrepreneurs resided with entrepreneurs themselves, we designed a survey questionnaire and administered it to a large sample of technology entrepreneurs across the United States.

In order to transform our research questions into a survey questionnaire, we undertook extensive research and conducted numerous interviews with experts in the

field and with active entrepreneurs. During this process, we examined the theoretical and empirical literature in law, economics, management, and other social sciences to develop a series of hypotheses.<sup>21</sup> We also drew heavily from prior innovation surveys.<sup>22</sup> Furthermore, our research team held discussions with scholars, university technology-transfer officers, independent inventors, startup founders and executives of early-stage companies, Silicon Valley lawyers, managers of venture capital firms and angel investors to better understand the entrepreneurial environment and to craft questions that would shed light upon topics that were not well understood, or for which there were conflicting explanations.<sup>23</sup>

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<sup>21</sup> Some of the sources for the ideas covered by our questions include Wesley M. Cohen, Richard R. Nelson & John P. Walsh, *Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (Or Not)* (NBER Working Paper 7552, Feb. 2000); Joshua Jackson, *The Usefulness of the General Social Surveys Database in Entrepreneurship and Small Business Research* (2002); Richard C. Levin, Alvin K. Klevorick, Richard R. Nelson & Sidney G. Winter, *Appropriating the Returns From Industrial R&D*, 18 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 783 (1987); Jerome A. Katz, *The Logic and Opportunities of Secondary Analysis in Entrepreneurship Research*, in 4 JEROME A. KATZ, ED., *ADVANCES IN ENTREPRENEURSHIP, FIRM EMERGENCE, AND GROWTH: DATABASES FOR THE STUDY OF ENTREPRENEURSHIP* 5 (2000); Edwin Mansfield, *Patents and Innovation: An Empirical Study*, 32 *MANAGEMENT SCIENCE* 173 (1986); Edwin Mansfield, Mark Schwartz & Samuel Wagner, *IMITATION COSTS AND PATENTS: AN EMPIRICAL STUDY*, 91 *THE ECONOMIC JOURNAL* 907 (1981); Jerry G. Thursby & Marie C. Thursby, *Who Is Selling the Ivory Tower? Sources of Growth in University Licensing*, 48 *MGMT. SCI.* 90 (2000).

<sup>22</sup> Among the surveys we examined were Georgia Institute of Technology, *Inventors and their Inventions: Understanding the Innovation Process* (2007), <http://www.prism.gatech.edu/~jwalsh6/inventors/InventorQuestionnaire.pdf>; American Intellectual Property Law Association, *The AIPLA Economic Survey (2005 & 2007)*; Purdue University, *Purdue Licensing Survey* (1998); Carnegie Mellon University & The Alfred P. Sloan Foundation, *Research and Development in the United States* (1994); National Science Foundation, *The Manufacturers' Innovation Survey* (1993).

<sup>23</sup> We had fruitful discussions concerning our questionnaire design with Hank Barry (Hummer Winblad Venture Partners), James Bessen (Boston University), Wes Cohen (Duke University), Tom Ciotti (Morrison & Forrester, LLP), John Duffy (George Washington University), Brad Feld (Foundry Group), Rich Gilbert (UC Berkeley), Bob Glushko (UC Berkeley), Christoph Grimpe (ZEW), Dominique Guellec (OECD), Bob Gunderson (Gunderson Dettmer), Bronwyn Hall (UC Berkeley), Dietmar Harhoff (Ludwigs-Maximillian University), Bob Lee (UC Berkeley Survey Center), Mark Myers (University of Pennsylvania), Sean O'Connor (University of Washington), Lee Van Pelt (Van Pelt, Yi & James, LLP), and John Walsh (Georgia Institute of Technology), whom we thank for their insights.

A. *Our Focus Was on Technology Startups*

1. Targeting “Entrepreneurial Companies” and Their Top Executives

The economist Daniel Spulber has critiqued the relative underrepresentation of the “entrepreneur” in classical economic theory.<sup>24</sup> In his view, entrepreneurship does not begin until the individual forms a startup firm, and during the startup phase the individual and the enterprise are inexorably intertwined.<sup>25</sup> Spulber writes:

Entrepreneurs play a central role in the economy because they are the prime movers—the makers of firms. . . . The general theory of the firm places the entrepreneur at the center of microeconomic analysis. The entrepreneur engages in transactions that are needed to establish firms. In turn, firms create markets and organizations.<sup>26</sup>

According to this theory, the period of entrepreneurship does not end until a true separation of ownership and control occurs.<sup>27</sup>

We approached the problem of surveying “entrepreneurship” in a manner consistent with that suggested by Spulber. While there are many pathways to understanding patenting and entrepreneurship, we elected to survey “entrepreneurial companies”—defined by us as companies founded in the United States during the last 10 years.<sup>28</sup> Given our research questions stated above, we were particularly keen to uncover the realities of patenting and entrepreneurship instead of the intentions or attitudes of entrepreneurs vis-à-vis patenting. Noting the almost complete lack of empirical data on

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<sup>24</sup> DANIEL F. SPULBER, *THE THEORY OF THE FIRM: MICROECONOMICS WITH ENDOGENOUS ENTREPRENEURS, FIRMS, MARKETS, AND ORGANIZATIONS* (2009).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 151.

<sup>27</sup> *Id.* The separation of ownership and control has been a cornerstone of the economic theory of the firm for decades. See ADOLF A. BEARLE & GARDNER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

<sup>28</sup> Entrepreneurs can run the panoply of “idea havens” to inventors to company founders. See generally David G. Blanchflower & Andrew J. Oswald, *What Makes an Entrepreneur?*, 16 *J. OF LABOR ECON.* 26 (1998); William B. Gartner, “*Who Is an Entrepreneur?*” *Is the Wrong Question*, 12 *AM. J. OF SMALL BUSINESS* 11 (1988); James W. Garland et al., *Who Is an Entrepreneur? Is a Question Worth Asking*, in *ENTREPRENEURSHIP: CRITICAL PERSPECTIVES ON BUSINESS AND MANAGEMENT* (Norris F. Krueger ed., 2002).

what entrepreneurs actually *do* when faced with decisions about intellectual property, we focused not on the intentions of would-be entrepreneurs, but rather on the “revealed” choices that entrepreneurs in firms actually made while innovating.

Such a research design fosters the ability to provide meaningful insights about the role that IP rights play in a wide class of entrepreneurial activities. For instance, focusing on the company allowed us to inquire into the entity’s age, employment, and share of scientists and engineers, and then relate these aspects to the company’s patenting choices. Moreover, this research design permitted us to ask about the sources and success at garnering external funding, and relate these responses to the usefulness and utility of seeking patents. Critically, unlike a few European studies of small firms,<sup>29</sup> we avoided focusing solely on existing patent holders, instead, surveying the broad class of “entrepreneurial companies” in order to offer insights into how the patent system is working for patentees and non-patentees alike.

Entrepreneurs generally become high-level executives of the firms they found and tend to be generalists who handle numerous aspects of their business.<sup>30</sup> Aware that many firms have more than one founder,<sup>31</sup> and driven by our interest in the innovation functions of the firm,<sup>32</sup> we targeted our survey questionnaire to chief executive officers

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<sup>29</sup> See Sichelman & Graham, *supra* note 10, at \_\_\_ (reviewing these studies).

<sup>30</sup> See Edward P. Lazear, *Balanced Skills and Entrepreneurship*, 94 AM. ECON. REV. 208 (2004) (noting that entrepreneurs are generalists who put together teams of people, assembling resources and capital, and, to be effective, they must have a general set of skills).

<sup>31</sup> See Brad Feld, *How Many Founders Does A Startup Need?*, Feld Thoughts (Feb. 25, 2007), at <http://www.feld.com/wp/archives/2007/02/how-many-founders-does-a-startup-need.html> (observing that startups tend to have two or three founders); Chan Chaiyochlarb, *If You Are Going to Launch a Startup, How Many Friends Would You Need?*, TESTING TESTING 1,2,3 (Feb. 23, 2007), available at <http://blogs.msdn.com/testing123/archive/2007/02/23/if-you-are-going-to-build-a-startup-how-many-friends-should-you-start-up-with.aspx> (electing a non-scientific sample and arrives at a figure of 2.09 founders for successful firms).

<sup>32</sup> We chose not to specifically target lawyers in the firm, on the theory that lawyers would tend to be comparatively more risk averse about divulging company information to outsiders.

(CEOs), presidents, and chief technology officers (CTOs). Over three-quarters of our respondents identified themselves as being one of these three officers.<sup>33</sup>

## 2. Selecting High Technology Sectors

Because we were principally interested in knowing how patenting affects the technology entrepreneurship process, we limited our field of study to certain “high technology” sectors. Given the extensive writing, opinion, and theory about the differences in innovation and patenting characteristics between the life sciences and information technologies firms, we focused primarily on companies in the biotechnology and software industries. As such, much of our analysis below compares and contrasts the results of our survey as regards companies operating in these two sectors. At the same time, we understood that other high technology industries are important drivers of dynamism and growth. Accordingly, we also surveyed companies in the medical device and IT hardware sectors (the latter defined as semiconductor, communications, and computer hardware), and when meaningful and relevant we report briefly here on their responses. While we are mindful that patenting may play an important role for startups in other industries,<sup>34</sup> much of the patenting and venture-funding activity among small firms takes place in our chosen high technology sectors.<sup>35</sup>

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<sup>33</sup> This figure is actually an undercount, since some respondents who were presidents called themselves instead “owners,” and other officers neglected to identify themselves as “chief technology officers” but instead as “VP of engineering” or “Chief scientist” or the like. As such, our yield in these three categories was closer to 85%. Among the “other” executives responding, they serve in many different functions, including those from the operations (about 15% of all others), finance (about 10% of all others), and in-house lawyers (about 7% of the others), as well as marketing/sales and development (each about 5% of all others).

<sup>34</sup> While the vast majority of our respondents fell into these four industry classifications, about 12% came from other sectors. Approximately 7% fell into medical technologies not either “biotechnology” or “medical devices,” and another 5% fell completely outside our technology definitions. For more

### 3. Choosing Companies to Survey

Because our research questions deal with how the patent system broadly affects technology entrepreneurship, we adapted our research design to two different types of entrepreneurial companies. First, we were interested in studying how patenting relates to the “average” entrepreneurial company. Second, we were keen to understand how the highest “quality” companies—namely, those most likely to generate innovations, succeed, and grow—were using the patent system. We therefore chose two groups to survey: those representing the “population” of firms and those that had been successful in securing venture capital (VC) funding. Unfortunately, there is no one association to which all high technology entrepreneurial firms belong.

After examining the available data sources, we selected Dun & Bradstreet (D&B) as a proximate window into the overall population of companies in the United States. D&B is a leading business credit-reporting and information source in the United States and holds over 140 million business records worldwide.<sup>36</sup> D&B conducts entrance interviews to assign a credit rating to the companies in its database during which it determines technology class and founding date. We used D&B’s data on technology

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information, see Stuart Graham & Ted Sichelman, *Patents and Innovating Startups: Analysis of the 2008 Berkeley Patent Survey* (Berkeley Center for Law and Technology Working Paper, 2009).

<sup>35</sup> See Robert E. Hall & Susan E. Woodward, *The Incentives to Start New Companies: Evidence from Venture Capital* (Apr. 2007), available at <http://imio.haas.berkeley.edu/WilliamsonSeminar/hall021408.pdf>.

<sup>36</sup> The company reports that “87 percent of D&B’s U.S. active file contains businesses with 10 or fewer employees.” Dun & Bradstreet, *Facts & Figures*, [http://www.dnb.com/us/about/db\\_database/dnbstatistics.html](http://www.dnb.com/us/about/db_database/dnbstatistics.html) (last visited May 24, 2009). Based on a rough comparison with aggregate U.S. Census data, we estimated that D&B contains about 60% of all companies founded in our target sample. See *Statistics of U.S. Businesses*, U.S. Census Bureau, available at <http://www.census.gov/csd/susb/susbdyn.htm>.



class<sup>37</sup> and founding date to construct a sample of 10,500 D&B-listed companies founded after December 31, 1997.<sup>38</sup>

We understood too, however, that an important segment of the population of companies—venture-backed firms—make up only a small portion of the overall population.<sup>39</sup> Prior research shows that this small share of firms is disproportionately responsible for innovative output in the economy,<sup>40</sup> and that venture-capital funding is related to patenting activity.<sup>41</sup> Because of our interest in understanding the role of patenting in startup investment, we chose to focus on this important class of companies by turning to the Thomson’s *VentureXpert* data, which reportedly covers a substantial share of venture-backed companies in the United States.<sup>42</sup> Using Thomson’s rich data on

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<sup>37</sup> Using the entrance interviews, D&B assigns companies to Standard Industry Classifications (SICs) which we relied upon to select which companies fell into each industry sector. SIC numbers are not sufficiently disaggregate to allow us to identify “biotechnology” companies—in the SIC codes, these companies are lumped together with other commercial researchers in SIC code 8731 “Commercial Physical and Biological Research” companies. We therefore relied upon D&B’s more fine-grained North American Industry Classification System (NAICS) coding to identify “biotechnology research” companies. The corresponding NAICS code is 541711. See U.S. Census Bureau, North American Industry Classification System, at [www.census.gov/naics/](http://www.census.gov/naics/) (last visited June 12, 2009).

<sup>38</sup> Our list included all D&B’s biotechnology companies (642) assigned to NAICS 541711, all medical-device companies (1,048) assigned to SIC 3841, and a random sample of its listed software companies (8,810) assigned to SIC codes 7371, 7372, 7373, and 7379.

<sup>39</sup> See Kortum & Lerner, *supra* note 1, at \_\_\_ (noting that venture backed firms account for 3% of all companies).

<sup>40</sup> *Id.* (noting that while venture-backed firms account for 3% of all companies, they account for 15% of the innovative output and a disproportionate amount of patenting).

<sup>41</sup> See Carolin Haussler et al., To be Financed or Not – The Role of Patents for Venture Capital Financing (Working Paper June 3, 2008), available at [www.aea-eu.com/2008Tokyo/DOCUMENTS/Publication/Abstract/HUSSLER\\_HARHOFF\\_MLLER.pdf](http://www.aea-eu.com/2008Tokyo/DOCUMENTS/Publication/Abstract/HUSSLER_HARHOFF_MLLER.pdf); Paul H. Jensen et al., Innovation, Technological Conditions and New Firm Survival (Melbourne Institute Working Paper No. 26/06, Nov. 2006), available at [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=946827](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946827); David B. Audretsch, Financial Signalling by Innovative Nascent Entrepreneurs (CEPR Discussion Paper No. DP7165, Feb. 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1345692](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1345692); Iain M. Cockburn & Megan J. MacGarvie, *Patents, Thickets, and the Financing of Early-Stage Firms: Evidence from the Software Industry* (Nat’l Bureau of Econ. Res., Working Paper No. W13644, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1037168](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1037168).

<sup>42</sup> VentureXpert draws its data from portfolio companies funded by over 1,000 private equity partnerships, of which 700 are venture funds, and holds information on the funding transactions of over 4,350 venture capital firms derived from industry surveys as well as quarterly and annual fund reports. . Thomson database descriptions, available at <http://vx.thomsonib.com/NASApp/VxComponent/VXMain.jsp>. But see Steven N. Kaplan et al., How Well Do Venture Capital Databases Reflect Actual Investments? (Working Paper, Sept. 2002), available at <http://ssrn.com/abstract=939073> (suggesting that VentureXpert tends to be

company characteristics, we selected 5,600 companies primarily in our target sectors that were founded in 1998 or later and received venture or similar institutional funding.<sup>43</sup> Combining our D&B and *VentureExpert* samples, our final list of target firms contained over 15,000 unique entities.<sup>44</sup>

*B. Profiling Our Respondent Companies*

In trying to profile the respondents in our survey, we are met with a difficult task. Since we purposefully set about to target entrepreneurial companies across a variety of characteristics (such as industries and age), an “average” respondent company cannot in fact exist. However, it is important to disclose how many of what types of companies responded to our survey. We therefore offer statistics on the response rates to our survey, followed by descriptive statistics on the characteristics of the companies that answered our questionnaire. Accordingly, we offer a first picture into the technology companies that answered our questionnaire.

Our “median” respondent (at the 50<sup>th</sup> percentile) is a self-described “startup” company founded in April 2002, and it has neither had an IPO nor been acquired. It has nine employees, half of whom are scientists or engineers. The company’s 2007 revenues were \$300,000 and its founders had prior experience running another company.

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biased toward California companies, and that most of the data comes from the investors, and not from the companies themselves).

<sup>43</sup> Thomson uses a proprietary industry classification that includes “Information Technology”, “Medical/Health/Life Science” and “Non-High Technology.” Of the over 11,000 US companies in their database as of May 2008 founded after 1997, about 65% were classed “Information Technology” and about 20% were assigned to “Medical/Health/Life Science.”

<sup>44</sup> We also administered our questionnaire to a group of companies in the “cleantech” (i.e., environmental technologies) market in conjunction with GreenTech Media, an online cleantech industry clearinghouse. Because we have a strong reason to believe that this sample was not representative of the population of cleantech startup firms, we do not report these results here. However, we plan to make these effectively “anecdotal” reports available.

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Geographically, the company's offices are located somewhere west of the Mississippi river. In terms of funding its operations, the "median" respondent from our D&B sample has received funding from "friends and family," at least one "angel" investor, and from a commercial bank, but not from venture capital, investment banks, or other companies.

Excluding our pre-test responses, 1,332 unique companies responded to our survey. Overall, this figure produces an 8.7% response rate. This "uncorrected" response rate does not account for companies that could not be reached, either because the quality of the contact information we had was inaccurate, or because the firm had gone out of business or reorganized so fundamentally that they could not be reached. We revised this base response rate by first correcting for returned mail (evidence of inaccurate physical address)<sup>45</sup> and second by reference to the results of the random-sample telephone calling we did during the fall of 2008.<sup>46</sup>

For the D&B sample, we achieved a 7.0% response rate, and after correcting for bad addresses that figure becomes 8.4%. Correcting further for telephone failures, that figure rises to 10.6%. In the *VentureXpert* sample, we achieved a 12.4% response rate among companies for which we had emails.<sup>47</sup> After accounting for mailing and telephone failures, the corrected response rate is 17.9%.

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<sup>45</sup> The US Postal Service returned approximately 17% of our mailings with a "return to sender," "unable to forward" and "no longer at address" stamp. It is likely that this figure is low since the Post Office returns less than 100% of non-deliverable mail, particularly when that mail, like ours, is not a first-class mailing.

<sup>46</sup> We found on average that 23% of the companies could not be reached by telephone, though this figure was substantially higher in some sectors (e.g., 41% for venture-backed biotechnology firms).

<sup>47</sup> We had an email address for at least one officer in 68% of the *VentureXpert* companies. Our testing shows that there are in general no significant differences in the way that the emailed and non-emailed (mail only) *VentureXpert* companies answered our survey. See Graham et al., *supra* note 34.

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In addition to higher response rates from *VentureXpert* companies, responses from “medical” firms were substantially more likely than from IT companies.<sup>48</sup> In the D&B sample, the (telephone and mail-corrected) response rate for biotechnology and medical device firms is 23.7% and 13.4%, respectively. For software and Internet companies, that same figure is 8.9%. Among the *VentureXpert* sample, the (fully corrected) response rates for “medical” (biotechnology and medical device) as compared to information technology (hardware and software) companies are 24.2% and 15.6%, respectively.<sup>49</sup>

We find that, by and large, our respondents are not statistically different from the non-respondents on key company characteristics. Within industries, we find generally no reportable difference in the age, sales volume, and employee counts between respondents and non-respondents.<sup>50</sup> We also recognized that more active patentees may have selected into our “patenting” survey, so we matched our respondent and non-respondent companies to the U.S. Patent & Trademark Office (USPTO) patent record. Again, we find no significant differences between the two groups in terms of the number of patents held by the companies, nor in the number of applications filed since 2001.<sup>51</sup> While we do

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<sup>48</sup> In this regard, because of reported importance of patenting to biotechnology companies, we took extra efforts to contact this group, telephoning every non-respondent, typically multiple times.

<sup>49</sup> Based on our telephone calling, we also found that approximately 23% of IT companies and 35% of biotechnology companies were not reachable at the telephone number provided in the public record. As such, our effective response rates are likely higher than the conservative ones reported here.

<sup>50</sup> D&B software respondents are approximately one-half year younger than non-respondents when we measure on the year (not date) of founding (significant at the 95% confidence level). Responding D&B medical-device companies have more employees than non-respondents (38 versus 14, a result which is weakly significant at the 90% confidence level).

<sup>51</sup> We can only see published applications after 2001 in the United States. We also tested for the number of patents (and applications) per year of age of the company, and again found no significant differences. See Graham and Sichelman, *supra* note 34, at \_\_\_.

see a “western bias” in our respondents, we nevertheless have confidence that our respondents are not dissimilar in important respects to our non-respondents.<sup>52</sup>

One of the main findings of our survey is that venture-backed companies are significantly different in the way they view the innovation, technology competition, and patenting processes. As such, we often report their responses separately in this article. When these differences are not important, we combine the results.

### III. PATENT HOLDING IN TECHNOLOGY STARTUPS

#### A. *Patent Holding Among Startups Is Widespread but Not Ubiquitous*

##### 1. Startups’ Patents Come from Several Different Sources

Because we asked respondents to report the numbers of patents and applications they held and their origin, our survey results offer a uniquely accurate window into the patenting behavior of early-stage technology companies. In the past, scholars have tried to match granted patents in the USPTO database to company names by using data in the “assignee” field. This method tends to undercount patents because it often misses patents that were assigned to the company from the founders or otherwise acquired from outside the firm.<sup>53</sup> While scholars have generally not used the USPTO reassignment data to supplement the original assignments, even in this regard the USPTO records on patents

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<sup>53</sup> Although published patent applications have recently become available in the United States, they too cannot be relied upon either to give accurate results. First, they have been published only since 2001. Second, they are published only after 18 months, which means that the most recent applications cannot be counted. Third, there is a class of patent applications that do not require publication. Applicants can disclose to the Patent Office that they do not intend to seek patent protection in any other jurisdiction with an 18-month publication rule and opt out of the requirement. *See* 35 U.S.C. § 122(b)(2)(B) (2001). Estimates vary, but it is believed that between 5-15% of applications are taking advantage of this rule. *See* STUART GRAHAM, CONTINUATION, COMPLEMENTARITY, AND CAPTURING VALUE: THREE STUDIES EXPLORING FIRMS’ COMPLEMENTARY USES OF APPROPRIABILITY MECHANISMS IN TECHNOLOGICAL INNOVATION (2004) (unpublished Ph.D. dissertation, U.C. Berkeley) (on file with the U.C. Berkeley Library). Additionally, small firms are among the most likely to elect non-publication, since they are comparatively less likely to market their products outside the United States. *See* Mark D. Janis, *Patent Abolitionism*, 17 BERKELEY TECH. L.J. 899, 919 (2002).

reassigned to different entities after grant are notoriously incomplete.<sup>54</sup> Further compounding the difficulty of knowing “what patents companies have” is the problem of name-matching, which stems from the multiple forms of company names, corporate name changes, and typographical errors in the patent records themselves.<sup>55</sup> Moreover, arriving at accurate counts may be particularly difficult for early-stage companies since—as our survey results show—it is common for their patents to originate with founders prior to the company’s founding date. Such patents may first issue to founders (as individuals, with no initial corporate assignee) and only later be assigned to the company. Because startups are resource constrained (in money and time), it may be less likely that these companies update their assignment records at the Patent Office. Effectively tracking these patents would require knowing the names of the founders and matching these to the USPTO patent inventor records. And with common names, that second task can be a herculean labor.<sup>56</sup>

Our survey results are not prone to these difficulties, and thus offer superior information about the patent holdings of early-stage technology companies. Instead of relying on “matching,” we asked our respondents to report to us the number of U.S. patents or filed applications held by the company from three unique sources: those coming from founders applied-for prior to the company founding date; those acquired by

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<sup>54</sup> The recording of assignments appears to be routinely ignored. *But see* 35 USC § 261 ¶ 4 (establishing a registration system). In essence, the law establishes a registration system with a notice statute protecting subsequent purchasers for value. The registration system is organized in a fashion analogous to a “land deed” registry, in which the person or entity who purchases later without notice of an earlier transfer prevails over the earlier transferee, if it did not record within a grace period.

<sup>55</sup> For instance, the assignee “Minnesota Mining and Manufacturing Company” also appears as assignee “3-M” in U.S. Patent No. 4,000,444 (filed Mar. 12, 1973).

<sup>56</sup> *See* Manuel Trajtenberg, Gil Shiff & Ran Melamed, *The “Names Game”: Harnessing Inventors’ Patent Data for Economic Research* (NBER Working Paper No. 12479, Aug. 2006) (discussing the difficulty of the inventor name-matching problem).

the company from sources other than its founders; and those filed by the company itself after its founding date.

Table 1: Patents Held by Startup Companies

Source	Industry	All respondents	Biotechnology	Medical Devices	Software	IT Hardware <sup>‡</sup>
<b>Population of companies (D&amp;B)</b>						
Companies holding patents (share)		39%	75.0%	76%	24%	--
Average # patents held (all companies)		4.7	9.7	15.0	1.7	--
<b>Venture-backed companies</b>						
Companies holding patents (share)		82%	97%	94%	67%	91%
Average # patents held (all companies)		18.7	34.6	25.2	5.9	27.4

Based upon two questions. “Does your company own U.S. patents or has it applied for U.S. patents (including any patents or applications acquired through any purchase or transfer)?” and “How many, if any, U.S. patents or pending applications does your company have from the following sources: Patents or pending applications applied for by Founders prior to the company’s founding date? Patents or pending applications purchased, transferred, or assigned to company? Patents or pending applications filed by your company since founding?” ‡ Available only for *VentureXpert* listed companies.

## 2. Startups Hold Numerous Patents, but Explanations Are Nuanced

Because studies relying on the USPTO database had reported average patent holdings for venture-backed startup companies in the range of 0.5-6.0 patents,<sup>57</sup> we were surprised to find that, on average, the companies in the “population” of hi-tech firms (as proxied by D&B) hold well over 4 patents and applications (4.7; See Table 1). Among the venture backed firms in our survey—a more comparable sample to previous studies—the average firm holds just under 19 patents and applications (18.7). These figures are somewhat misleading, though: Among the D&B respondents, over six in ten companies

<sup>57</sup> Ronald J. Mann & Thomas W. Sager, *Patents, Venture Capital, and Software Start-ups*, 36 RES. POL’Y 201, 203, 204 (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=802806](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=802806).

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(61%) hold no patents at all. Moreover, these average statistics are influenced by a few patent holders with very large portfolios: for instance, one of the respondents in our D&B sample reports holding 260 patents and applications from all sources. Similarly, one venture-backed company holds 570 patents.

We observed earlier that there are important differences between venture-backed startups and companies drawn from the overall population (most of this latter set having no venture investment)—and this observation applies also to patent ownership. For instance, among those startups drawn from the D&B sample (approximately 85% of which has no venture backing), the median company (the firm at the 50th percentile) holds no patents or applications. Venture-backed companies are substantially different than the D&B “population” of startups: the median venture-backed firm holds six patents. Among venture-backed firms, a comparatively small 18% hold no patents or applications from whatever original source, about one-third the share exhibited by the D&B companies.

These findings suggest that the holding of patents by technology startups is more widespread than previously believed, especially among venture-backed companies, but that holding patents is by no means ubiquitous among entrepreneurial firms. Substantial numbers of early-stage technology companies appear to be “opting out” of the patents system altogether, and these firms are not merely clustered among the younger companies. In fact, the likelihood of not holding any patents is virtually the same among the youngest companies and the oldest ones in our study. For example, among the older D&B companies in our sample (those founded prior to 2003), 64% of firms report



holding no patents.<sup>58</sup> Therefore, the likelihood of holding (or not holding) patents by technology startups does not appear to be driven by age effects, but instead by the company's business model, strategy, technology, or other factors.<sup>59</sup>

### 3. Technology Entrepreneurs Suggest the Patenting Story is Complex

To better understand the underlying rationale of our respondents' answers, we conducted several hour-long, follow-up interviews by telephone in the early months of 2009. The comments of one such executive, to whom we refer as Neil, are illustrative of what is often a tension for the entrepreneur in deciding whether to seek patent protection. Neil is the inventor of an innovative biometrics information technology, and CEO of a startup he founded in 2003 to commercialize the technology. While his company has filed one patent that has not yet been granted, he has generally tried to avoid patents even though his investors, which include venture-capital firms, were interested in him having them. He stated:

Our business is a consumer services business; it was never my intention to be a monopoly and to protect [this technology] . . . . Instead, our strategy is to grow as the number one supplier of [our new product] while simultaneously allowing other, smaller companies to spread [the underlying technology] around the nation. In doing so, [the technology] will have a huge consumer base and our company will be viewed as *the* prominent player, much like 'Kleenex' is in the tissue industry.<sup>60</sup>

Neil's comments are indicative of several streams running through our survey responses. First, patenting is common among our respondents, but by no

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<sup>58</sup> We note that there is not a hidden "technology" effect to these findings: The share of companies that are identified as biotechnology, medical devices, or software are virtually identical among the older and younger companies.

<sup>59</sup> Among those firms that chose to hold patents, however, there is a positive influence of age on the number of patents held. See Graham et al., *supra* note 34.

<sup>60</sup> Interview with anonymous executive, March 2009 (emphasis in original).

means ubiquitous. Second, patenting for the entrepreneurs choose to hold patents is often motivated by reasons that have not commonly been well-understood or studied in the previous literature. And, third, the incidence and usefulness of patents to technology entrepreneurs is very much determined by the industry and technology in which the company is operating.

*B. In Patenting, Not All Startups Are Created Equal*

1. Industry Influences the Incidence of Startups Holding Patents

Similar to the patenting differences associated with the presence of venture funding, we find profound disparities in the likelihood, number, and original source of patents by the technology focus and industry of the company. Among the D&B sample, biotechnology research and medical device companies are much more likely to hold patents and applications than are software and Internet firms (Table 1). In fact, three out of four of these “medical” companies report holding patents and applications compared with only one in four among software startups.

There are also substantial differences across industries in the number of patents held on average, with the total patents of medical and life science companies once again substantially greater than those of the software and Internet firms in the D&B sample. Medical device companies report holding 15 patents and applications on average, compared to just under 10 for biotechnology research companies. These figures are significantly higher than for software companies, which hold on average less than two patents and applications. Much of this difference is driven by the relatively low likelihood of software firms holding patents. If we compare the average count of patents

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and applications held by firms that have chosen to patent, D&B software and Internet firms compare more closely with D&B biotechnology research companies (7.1 patents to 12.9 patents, respectively). But here, too, large patent-portfolio companies influence the result: among those D&B companies that hold patents, the median software startup (at the 50th percentile) holds two patents and applications and the median biotechnology firm possesses six.

While there are substantial inter-industry differences at the level of the average D&B company, focusing instead on those companies choosing to hold patents demonstrates smaller or insignificant differences as to the *origin* of the patents held by the firm. Across the D&B patent holders, about two patents and applications come into the firm from its founders, and while this number falls to nearly one for the (fewer) software and Internet companies holding patents, the difference is not statistically meaningful. For every ten employees at a patent-holding D&B company, the firm files seven patents on average, and it acquires two patents or applications from sources other than its founders. These figures change little based on the technology of the company, and the differences are not statistically meaningful. In sum, for startup companies that hold patents, the likely origin of those patents remains virtually the same regardless of the technology focus of the firm. What is significantly different, though, is the likelihood of holding *any* patents—software and Internet companies in the population (as proxied by D&B) are much less likely to hold patents than similar companies involved in the health-related technologies.

## 2. Venture-backed Companies Are More Likely to Hold Patents

These inter-industry differences persist too among the venture-backed firms, where the incidence of holding patents is much higher and the origins of those patents are more varied. Table 1 shows that virtually all (19 of 20) companies in the biotechnology and medical-device sectors hold patents—and while holding patents is less likely for venture-backed IT firms (hardware and software alike), the rates are still relatively high (about 90% and 70%, respectively). Venture-backed firms are much more likely to hold patents, regardless of technology focus.<sup>61</sup>

In order to better understand the motivations for venture-backed companies to patent, we interviewed several partners at VC firms. One such partner holds an engineering degree, invests primarily in biotechnology companies, and has extensive experience in the technology, business, and investment environments in which his portfolio companies operate. He stated:

When you go into life sciences—and in reality, with any [bio-related technology] that you’re creating or acquiring—if it doesn’t have a reasonably strong patent, and if you don’t have the capability to expand the patent estate covering your technology and products, you are going to have complicating issues. [As a young company], you need to secure patents, and with the broadest claims and specifications that you can get.<sup>62</sup>

These comments support two clear messages that spring from our responses. First, early-stage biotechnology companies are much more likely to use, and to see utility in using, the patent system. Second, venture investors are interested in patents, and venture-capital backed companies are much more likely to hold and file for patents. Whether this second observation is primarily driven by investors demanding a more active patent “footprint”

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<sup>61</sup> The finding that venture-backed firms are substantially more likely to hold patents is consistent with an earlier study finding that venture-backing has a positive influence on patenting. See Kortum & Lerner, *supra* note 1.

<sup>62</sup> Interview with anonymous partner, May 2009.

of the companies they fund or by companies that VCs fund simply being more likely to supply patents to investors, we are unable to say with certainty. Our evidence points, however, to a relationship that runs both ways. Firms that seek venture-funding appear to be patenting more actively prior to the funding event (and for the purpose of securing funding), and venture-capital investors appear much less willing to fund companies that hold no patents.

In this sense, the results of our survey differ substantially from several prior studies of startup patenting. In particular, we show that among venture-backed companies, patent-holding is more widespread and—in conjunction with additional data we present below—more important to securing venture investment than previously reported. The best prior evidence on the topic comes from Ronald Mann and Tom Sager, who matched venture-backed companies to the Delphion patent database.<sup>63</sup> Their article reports that venture-backed software firms hold on average just under three patents, while venture-backed biotechnology companies possess just under 5.5 patents. Moreover, they state: “[O]nly 2% of software firms had more than four patents, while less than 1% of all software firms had more than ten patents; 19% of biotechnology firms had more than four patents and 6% had more than ten patents.”

Our responses from startup company executives show that holding patents (and applications) is much more prevalent. Our respondent venture-backed software and Internet firms hold on average just under 6 patents and applications, double that estimated by Mann and Sager, while venture-backed biotechnology companies hold just under 35 patents, more than six times greater than the Mann and Sager count. If we restrict ourselves only to patents filed by these firms (thus more closely approximating Mann and

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<sup>63</sup> See Mann & Sager, *supra* note 57, at 196.

Sager's patent-matching-and-counting method), our venture-backed software respondents report filing 4.9 patents on average, while venture-backed biotechnology companies file 22.2 at the mean—still substantially higher than the figures cited by Mann and Sager.

Unlike Mann and Sager's estimates, 63% of venture-backed software and Internet startups reported holding more than four patents and applications, while more than 47% of all software firms reported holding more than ten. Comparing these figures to venture-backed biotechnology startups, we find that 86% of these companies report having more than four patents and applications while 60% hold more than ten. These differences with Mann and Sager may be partly accounted for by the reality that not all applications result in an issued patent,<sup>64</sup> although in startups the grant rate may in fact may be higher because (a) the quality of the invention may be higher than on average<sup>65</sup> and (b) the patent applicants themselves may care more about winning a granted patent, and thus expend more time, effort, and money to win the patent right.<sup>66</sup> We also find that in the IT sector, hardware companies are holding significantly more patents than their software counterparts: venture-backed IT hardware firms hold on average more than 27 patents

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<sup>64</sup> There is conflicting evidence about the USPTO's application grant rate. See Cecil D. Quillen, Ogden H. Webster & Richard Eichmann, *Continuing Patent Applications and Performance of the U.S. Patent and Trademark Office - Extended*, 12 FED. CIR. BAR J. 35 (2002); Robert A. Clarke, *U.S. Continuity Law and its Impact on the Comparative Patenting Rates of the US, Japan and the European Patent Office*, 85 J. PAT. & TRADEMARK OFF. SOC'Y 335 (2003) (responding to an earlier study by Quillen and Webster); Ron D. Katznelson, *Bad Science in Search of "Bad" Patents*, 17 FED. CIR. BAR J. 1 (2007/2008) (discussing problems involved in grant rate calculation); Mark A. Lemley & Bhaven N. Sampat, *Is the Patent Office a Rubber Stamp?* 4-9 (Stanford Public Law Working Paper No. 999098, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=999098](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=999098) (pointing to data controversies in calculating patent grant rates).

<sup>65</sup> See Kortum & Lerner, *supra* note 1, 690 (finding that venture-backed firms' patents have significantly more forward citations than the population of patents). *But cf.* Jean O. Lanjouw & Mark Schankerman, *Protecting Intellectual Property Rights: Are Small Firms Handicapped?*, 47 J. L. & ECON. 45 (2004) (finding that patent portfolio size is positively related to patenting).

<sup>66</sup> See generally Stuart J.H. Graham & Dietmar Harhoff, *Can Post-Grant Reviews Improve Patent System Design? A Twin Study of US and European Patents*, CEPR Discussion Paper 5680, available at <http://ideas.repec.org/p/cpr/ceprdp/5680.html> (suggesting higher grant rates among triadic patents demonstrate that extra effort pays off in winning patents).

and applications, about five times more than similarly-funded software and Internet companies.

Another noteworthy finding of our study is that founders bring substantial numbers of patents and applications with them into their startups. This finding offers another possible source for our differences with Mann and Sager's estimations: the failure to account for these "founder-added" patents.<sup>67</sup> We find that when a D&B listed biotechnology startup holds patents, its founders tend to bring on average two patents and applications into the firm, a figure that nearly doubles to 3.8 when the firm has venture backing.<sup>68</sup> Venture-backed medical device and IT/hardware firms that hold patents tend to acquire more than three patents and applications on average from their founders. However, for patent-holding software companies with venture funding, founders are likely to bring fewer than one patent (or application) with them into the startup.<sup>69</sup>

After founding, venture-backed biotechnology and medical device companies are also more likely than are software and Internet firms to file patent applications and to acquire patents (or applications) from sources other than their founders. For these "medical" firms that hold patents or applications, they report that on average eight originate from acquisitions (other than from founders), and that they directly file twenty applications. These figures are substantially higher compared to the just over 0.5 patents or applications acquired on average by venture-backed software and Internet firms, and the seven directly filed by these startups. Interestingly, IT hardware firms are the outlier: These companies are more like the "health-related" firms in terms of their number of

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<sup>67</sup> As mentioned

<sup>68</sup> These differences are significant at the 95% confidence interval.

<sup>69</sup> It is noteworthy that, among software firms, the average number of founder-originating patents is lower for venture-backed companies (0.7 patents) than for those in the D&B population sample (1.2 patents), although this difference is not statistically significant at conventional levels.

founder-originating patents and patent filings, but are also similar to their software counterparts in that they tend to acquire comparatively few patents from sources other than founders.

*C. Patents May Offer Only Limited Incentives to Engage in Innovation*

Given that the monopoly patents offer is most commonly justified on the ground of providing incentives to innovate, we were surprised to find that, in general, the technology startup executives responding to our survey report that patents are offering relatively weak incentives to engage in innovation. In this context, we refer to the term “innovation” in its Schumpeterian sense—the series of steps taken from idea to invention to development to commercialization.<sup>70</sup> To uncover patents’ incentive value, our questionnaire asked all respondents how strong or weak an incentive (1=not at all, 2=weak, 3=moderate, and 4=strong incentive) patents served for undertaking four innovation-related activities: (a) inventing new products, processes or services; (b) conducting initial research and development; (c) creating internal tools or processes to build or implement final products, processes, or services; and (d) undertaking the risks and costs of making, selling, and marketing a commercial product. In general, the executives we surveyed reported that patents serve as only slight to moderate incentives for each of these stages in the innovation process.

We recognized during the design stage of our survey instrument that the meaning of the term “incentive” could be interpreted in several ways by our respondents. While we cannot dismiss the possibility that our respondents may not have understood the term “incentive” in the way that classical theory generally presents it, our preliminary testing

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<sup>70</sup> See JOSEPH A. SCHUMPETER, *supra* note 1, at 66 (contending that innovation consists of novel goods, production methods, markets, production inputs, and forms of organization).



and interviews suggested to us that the business-savvy technology entrepreneurs we surveyed do interpret that term in the way that lawyers and economists generally use it. While we are thus reasonably confident that our responses capture at least a proximate window into the incentive role that patents are playing for technology entrepreneurs, we nevertheless recognize that further research into the interesting findings we report is warranted.

### 1. The Reported Relatively Weak Incentive Value of Patents

Among the D&B companies, respondents told us that patents on average offer only marginally above a “slight incentive” to engage in invention, R&D, and commercialization, and between “slight” and “no incentive at all” to create internal tools and processes. While venture-backed startup executives rate the incentive value more highly than do those at D&B companies, in no category are patents reported to provide even a “moderate” incentive for any of the four entrepreneurial activities about which we queried.

An interview we conducted with the sole proprietor of a medical-device company assisted us in understanding some of the low-powered incentives that patents offer. This physician-turned-entrepreneur—whom we call Jeremy—has chosen largely to opt out of the patent system. As is the case with many innovations in medical devices, Jeremy was a “user-innovator,” seeing a practical problem in his medical practice that needed a practical response.<sup>71</sup> He founded his company to offer a product to meet that need, and quickly secured a patent. This lone patent, however, has not allowed him to compete effectively, and he perceives very little incentive to seeking patent protection today:

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<sup>71</sup> See generally ERIC VON HIPPEL, *DEMOCRATIZING INNOVATION* (2005).

## *HIGH TECHNOLOGY ENTREPRENEURS AND THE PATENT SYSTEM*

Fifteen years ago, patents were probably very useful and offered a lot of protection. But not today. In fact, today they are not very valuable at all, and, even if I were to get a patent on my [updated technology], odds are that I would still find a copy for sale on the side of the road in China.<sup>72</sup>

Jeremy's comments highlight two aspects associated with the incentive value of patents expressed in our survey responses. First, respondents tell us in general that the incentive value provided by patents is typically low for a range of innovative activities. Second, the pattern of reporting relatively weak incentives generally holds not just for those companies that do not patent, but also among those companies that do.

To verify that those companies holding patents were also reporting relatively low incentives, we divided our respondents into those companies that told us they held at least one patent or application from those holding none. We show that, as we expected, companies expending resources to acquire patents rate their incentive value higher in all categories than do those companies forgoing patenting. However, the incentive value that these "active patent holders" ascribe to patents still does not, for any of the four innovative activities, reach on average even the "moderate incentive" level. And for those companies that report holding zero patents or applications, the incentive value of patents is ranked by respondents on average between "slight incentive" and "no incentive at all" for each of the four innovation activities.

These findings are noteworthy given the legal and theoretical bases for the "patents as incentives" view. The U.S. Constitution, the basis for the intellectual property laws in the United States, provides for patents primarily upon the incentive view.<sup>73</sup> And at least since Kenneth Arrow's 1962 seminal work on the value of intellectual property in spurring research and development, economists have been

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<sup>72</sup> Interview with anonymous founder, February 2009.

<sup>73</sup> See U.S. Const. art. I, § 8, cl. 8 ("Progress of the useful arts.")

pointing to the value that society gains from offering patents (in the form of limited monopolies) to “idea havens” as an incentive to convert those ideas into inventions.<sup>74</sup> Noting that patent rights generally live well beyond the creative spark of invention,<sup>75</sup> other scholars have suggested that patents serve as incentives throughout the innovation process, across a range of entrepreneurial activities.<sup>76</sup> So if, as our findings suggest, patents are not serving as incentives to undertake the risks of innovation, what purpose are they serving?

## 2. The Multiple Meanings of Startup Patenting

The overall picture of startup patenting suggested by these two chief findings is surprising. On the one hand, startup companies in all high technology sectors are patenting much more widely, and in greater numbers, than we had reason to believe from the prior literature. However, when we ask top executives at these early-stage firms whether the patents that they are seeking (and for which they are devoting scarce resources) offer incentives to create, develop, and commercialize the technology that is at the core of the venture, they answer that, in general, patents are not serving that purpose even moderately well.

Our questionnaire design was such that we can shed light on this important conundrum. We find, and detail below, that patents are playing significant roles in technology entrepreneurship, even if the executives of startups assess their incentive value to be relatively weak. Some of these functions do concern patents’ traditional role in diminishing competition from third parties in the technological marketplace and the

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<sup>74</sup> See Arrow, *supra* note 4, at \_\_\_.

<sup>75</sup> See, e.g., SUZANNE SCOTCHMER, *INNOVATION AND INCENTIVES* \_\_\_ (2004).

<sup>76</sup> See, e.g., Sichelman, *supra* note 3, at \_\_\_.

related concern of securing profits from innovation—especially for biotechnology, medical device, and hardware firms (but notably less so for software and Internet companies). At the same time, patents appear to be supporting other activities crucial to *technology* startups: securing the necessary investment to develop and grow; increasing the odds and quality of a “liquidity event,” such as an exit or IPO; and, possibly, serving strategic roles in cross-licensing and defending against patent infringement suits.

What clearly springs from our data is a recognition that patenting is serving as an important institutional support for many activities that are being undertaken by technology entrepreneurs, and that are crucial to the success of technology entrepreneurship. But as some theorists have recently posited,<sup>77</sup> for many of these companies, patents do not provide the sorts of incentives to innovate that we long expected, although our findings suggest that they often serve other important roles in the process of entrepreneurship. We now turn to a fuller examination of these roles.

#### IV. FIRST FINDING: PATENTS AID STARTUPS IN COMPETING WITH THEIR TECHNOLOGIES

##### *A. Patents Can Serve to Promote Startups’ Competitive Advantage*

A major finding of our survey, and a partial explanation for the widespread use of patents by technology entrepreneurs, concerns the function that patents are serving in helping the startup compete with its innovative technology. Theory has long suggested that formal intellectual property rights (IPRs) are critical in protecting the lead-time or “first-mover” advantages that fast innovators possess.<sup>78</sup> Moreover, earlier surveys of managers at large U.S. companies have suggested that IPRs are an important means of

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<sup>77</sup> See Clarisa Long, *Patent Signals*, 69 U. CHI. L. REV. 625 (2002); Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 TEX. L. REV. 961 (2005).

<sup>78</sup> See Teece, *supra* note 9 (suggesting that both technological complexity and the strength of legal intellectual property rights are critical to protect the innovator’s advantage).

providing a competitive edge—but these same studies have found mixed results when considering patents specifically.<sup>79</sup>

Our survey results demonstrate that patenting plays a substantial role for many high-technology startups in securing a competitive advantage from their technology innovations—but that this finding is also context specific. In asking our sample companies about how meaningful patents were in the quest for profits and success, we attempted to disaggregate some of the answers from previous surveys, and also focused on startups. Specifically, previous studies tended to examine how large and publicly traded U.S. companies profit from their innovation.<sup>80</sup> Moreover, these surveys have generally failed to distinguish among important legal mechanisms, such as copyrights and trademarks.<sup>81</sup> While making these distinctions, our questionnaire also reproduced several elements from these previous surveys, such as “patenting” and “secrecy,” for the sake of consistency and comparison.<sup>82</sup> In the end, our questionnaire asked the respondent to indicate how important (or unimportant) the following seven items were to the company in securing competitive advantage from its technology innovations: first-mover advantage over competitors; secrecy; patents; copyrights; trademarks; difficulty of

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<sup>79</sup> Richard C. Levin et al., *Appropriating the Returns from Industrial R&D*, 3 BROOKINGS PAPERS ON ECON. ACTIVITY 783 (1987); Cohen et al., *supra* note 21.

<sup>80</sup> Levin et al., *supra* note 79; Cohen et al., *supra* note 21

<sup>81</sup> For example, the study by Levin and others included only patenting and secrecy as appropriability means. *See* Levin et al., *supra* note 79, at \_\_. The study by Cohen included patenting, secrecy, and “other legal” means. Cohen et al., *supra* note 21, at \_\_.

<sup>82</sup> The use in prior surveys of the term “secrecy” instead of “trade secret” presented us with a conundrum: We believed that the term “secrecy” could be interpreted by respondents to mean both more, and less, than “trade secret.” At the same time, we saw value in being as consistent as possible with prior surveys. Preliminary testing with respondents convinced us that the subjective understanding of the terms “secrecy” and “trade secret” did not differ substantially among respondents. As such, we decided to the term “secrecy.”

reverse engineering; and other production, implementation, or marketing capabilities. Hereafter, we call these seven methods “appropriability strategies.”<sup>83</sup>

How do young high technology companies capture competitive advantage from their technology innovations? Our results show that these early-stage firms are using multiple methods to compete with their technologies. Among all the companies responding to our survey, first-mover advantage is clearly ranked the most important: in fact, it is the only appropriability strategy ranked between “moderately important” and “very important” on average by all companies.<sup>84</sup> In the next ranked position are grouped three methods: secrecy, complementary assets, and patenting. These three are all rated on average between “slightly important” and “moderately important” by respondents, although ranked closer to the latter.<sup>85</sup> Ranked next according to all companies are the remaining three appropriability strategies: difficulty of reverse engineering, trademarks and copyright. All of these methods are rated between “slightly important” and “moderately important” by the respondents.<sup>86</sup>

This aggregation of all responses we received<sup>87</sup> offers a basic descriptive picture into our results: first-mover advantage dominates the other appropriability strategies as the most important method among technology startups for capturing competitive advantage from their innovations. This view of our data also suggests that other methods—including patents—are rated as having some importance, generally. In fact,

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<sup>83</sup> In so doing, we follow the nomenclature of the Cohen study. See Cohen et al., *supra* note 21, at \_\_\_.

<sup>84</sup> Scoring at the mean 3.3 on a 1-4 scale; significantly different from the next-ranked method at the 99% confidence interval.

<sup>85</sup> These methods score at the mean 2.8, 2.8, and 2.7, respectively, on a 1-4 scale; these three are not significantly different from each other, but are significantly different from the next ranked method at the 99% confidence interval.

<sup>86</sup> These methods score at the mean 2.6, 2.5, and 2.5, respectively, on a 1-4 scale; these three are not significantly different from each other in rank order, but the mean score for reverse engineering is significantly different from the mean score for copyright at the 99% confidence interval.

<sup>87</sup> Based on 1,236 companies that responded to this set of questions.

the difference between the average scores assigned to the other six methods is relatively small (even though some of these differences are statistically significant). However, this aggregation of our responses hides a highly nuanced story. In fact, when we examine companies' responses according to their different characteristics, such as the technology that they practice, or the type of funding they have secured, the rated importance of these different appropriability strategies—and pointedly patenting—tends to shift radically.

### 1. Industry Influences Patents' Role in Competitive Advantage

One cut of our data that allows us to see profound differences in the reported importance of patents, as well as other appropriability strategies, is segmenting by industry: for biotechnology, medical devices, and even IT hardware firms in our sample,<sup>88</sup> patenting is ranked among the most important means for startups to secure competitive advantage from their technologies (Figure 1).<sup>89</sup> Among biotechnology companies, we find that patenting is ranked the most important appropriability strategy.<sup>90</sup> For medical device startups and venture-backed IT hardware companies, respondents rank patenting second, behind “first-mover advantage.”<sup>91</sup>

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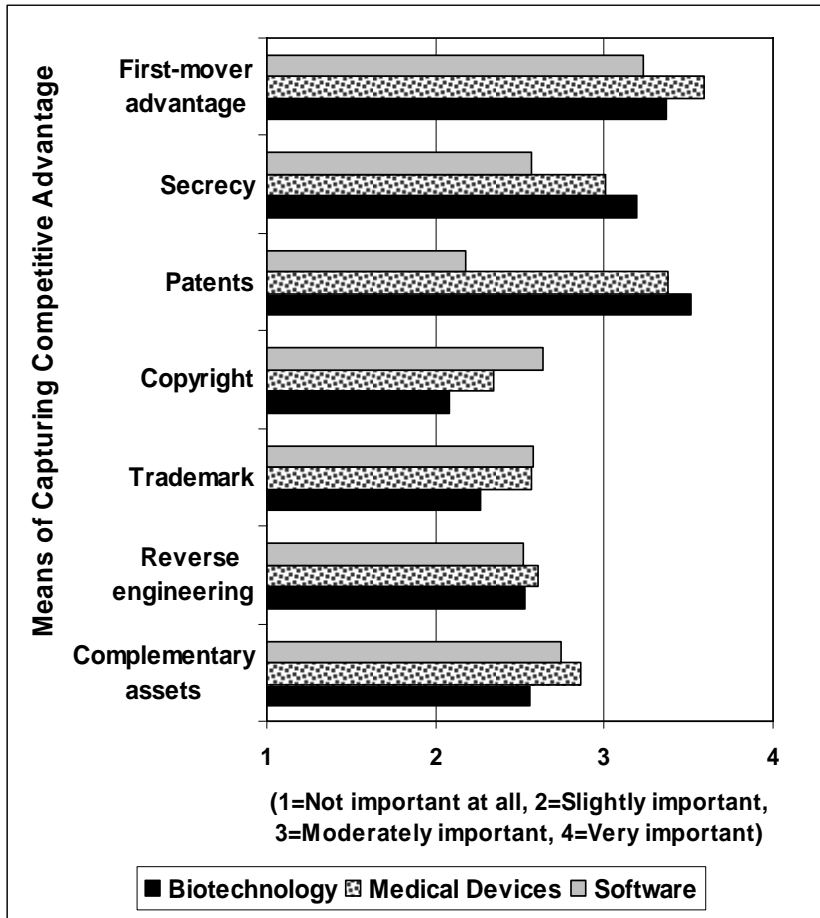
<sup>88</sup> We note that IT hardware companies are found only in our *VentureXpert* sample, and thus their responses we present here must be viewed through the overall lens of the increased likelihood of venture-funded firms to use the patent system.

<sup>89</sup> Figure 1 reports averages based on an equal-interval scale.

<sup>90</sup> The difference over the second most important, “first-mover advantage,” is statistically significant at the 90% confidence interval.

<sup>91</sup> In both cases, the differences between patenting and first-mover advantage were significant at the 95% confidence interval. The results for all medical device firms show that patenting is more important than the next most important method cited, secrecy, with a difference significant at the 99% level. Among the *VentureXpert* IT hardware firms, patenting was indistinguishable in importance from secrecy and reverse engineering, with all three essentially “tied” for second most important means—although each was significantly different from the next most important method, complementary assets, at the 95% confidence interval.

Figure 1: Capturing Competitive Advantage from Technology, by Industry



Question: “How important or unimportant is each of the following in your company’s ability to capture competitive advantage from its technology innovations?” (Averages reported).

Our biotechnology-company result deserves further attention. That a firm’s technology focus strongly influences how high-level startup executives judge the importance of different appropriability strategies is underscored by our results for all biotechnology companies combined. For this group of firms, patenting is ranked as the most important means of capturing competitive advantage.<sup>92</sup> Even when we exclude the *VentureXpert* firms and focus only on these D&B companies, patenting is still rated the

<sup>92</sup> Among these 171 respondents, “patents” is ranked first, and is significantly different than the second ranked “first-mover advantage” at the 90% confidence level.



most important method for sustaining competitive advantage among biotechnology startups.<sup>93</sup>

This biotechnology-firm finding presents an interesting possible divergence in the way that startup executives view the role of patenting as compared to the managers of large pharmaceutical companies. In their 1994 survey of large-company R&D managers, Cohen, Nelson, and Walsh report that secrecy was rated as the most effective appropriability mechanism by drug companies in both product and process innovation, but particularly in the latter category of innovation, for which secrecy was considered about twice as effective as were patents.<sup>94</sup> Our finding that, among early-stage biotechnology firms in 2008, patenting is the most important means of securing competitive advantage may suggest that large pharmaceutical companies view the importance of patents differently than do early-stage biotechnology firms, or that the importance of these strategies has changed for both types of firm over time, or some combination of these two effects.<sup>95</sup> In fact, we find that among all our biotechnology-company respondents, “secrecy” is in 2008 ranked third in importance to securing competitive advantage, following both patenting (first rank) and first-mover advantage (second rank).<sup>96</sup>

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<sup>93</sup> However, among the 101 D&B companies responding to this question, we cannot statistically differentiate between first-mover advantage, secrecy, and patenting.

<sup>94</sup> The study by Cohen et al., *see supra* note 21, asked respondents to report on the “effectiveness” of appropriability means, while we chose to follow the study of Levin et al., *see supra* note 79, and ask about their “importance.” Comparison is made more difficult by these semantic differences.

<sup>95</sup> This difference could also reflect that small-firm biotechnology research and the business of the large pharmaceutical company are considerably different. *See generally* Gary P. Pisano, *Can Science be a Business? Lessons from Biotech*, HARVARD BUS. REV. (Oct. 2006).

<sup>96</sup> The average “secrecy” rating of all these companies is significantly different from the “first-mover advantage” rating at the 95% confidence interval.

Also striking is the reported importance of patenting by venture-backed IT hardware companies.<sup>97</sup> The importance of patenting to venture-backed hardware firms is a noteworthy finding given that, in the 1994 Carnegie-Mellon Survey, firms in the IT hardware sectors (such as semiconductors or communications equipment) reported that patenting was only effective at protecting about one-quarter of their product innovations, compared to secrecy, which was effective at protecting about one-half.<sup>98</sup> In our results, IT hardware firms rank patenting at least as important as secrecy.<sup>99</sup> Clearly, for this selected sample of IT hardware companies, patenting plays a much more significant role in capturing competitive advantage from innovation than do larger firms surveyed over a decade ago.<sup>100</sup> Like the biotechnology companies, part of this difference may reflect the small size and lack of reliance upon complementary assets among our respondents. Another explanation could lie in industry changes, such as the rise of “fabless” semiconductor firms, which have been observed to be more dependent on patents than secrecy, since these firms license their inventions rather than taking them to market as products.<sup>101</sup>

The value of patenting among startups in biotechnology and medical devices (and venture-backed IT hardware) stands in stark contrast to the (un)importance ascribed to

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<sup>97</sup> We note that IT hardware firm responses exist only in the *VentureXpert* data, and that no D&B “hardware” respondents exist in our sample, so the reported averages represent only venture-backed companies.

<sup>98</sup> But, interestingly, undifferentiated “computer” companies in the Cohen survey reported that both patenting and secrecy were about equally effective. Cohen et al., *supra* note 21, at \_\_.

<sup>99</sup> While the average importance given to patents is greater than that of secrecy, the difference is not statistically significant at conventional levels.

<sup>100</sup> Interestingly, preventing reverse engineering—presumably through technical design—is a comparatively important method used to sustain competitive advantage for IT hardware as compared to companies in other sectors.

<sup>101</sup> See Bronwyn Hall & Rosemarie Ziedonis, *The Patent Paradox Revisited: An Empirical Study of Patenting in the U.S. Semiconductor Industry, 1979-1995*, 32 RAND J. ECON. 101 (2001); Ashish Arora & Marco Ceccagnoli, *Patent Protection, Complementary Assets, and Firms’ Incentives for Technology Licensing*, 52 MGMT. SCI. 293, 293 (2006).

patents by software and Internet firms. The limited function served by patenting in technology competition for early-stage software firms is underscored in Figure 1. In software, patenting is rated the least important among all the appropriability strategies.<sup>102</sup> When we focus only on companies in the D&B sample, patenting is still shown to be the least important method reported by software start-ups,<sup>103</sup> being ranked on average barely above “slightly important” by all D&B software-company respondents. Likewise, patenting is the lowest-rated method by venture-backed software companies, although for these companies it is not statistically different than other low-ranked methods.<sup>104</sup>

## 2. Patents’ Role in Technology Competition Differs by Innovation Focus

Among startups, we find that “product innovators” are substantially more likely than are “process innovators” to report that patenting is important in capturing competitive advantage. To relate the aforementioned appropriability strategies with the innovation focus of early-stage companies, we asked our respondents to disclose the importance (or unimportance) of various sources of innovation to their overall business strategy.<sup>105</sup> For two of these categories, *product* and *process* innovation, we were able to identify companies considering one of them as their primary innovation focus.<sup>106</sup>

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<sup>102</sup> Patents are ranked last, with the difference between patenting and the next lowest ranked method, reverse engineering, significant at the 99% confidence interval.

<sup>103</sup> For both the overall and D&B sample of software firms, patenting is rated the lowest by statistically significant margins (at the 99% confidence interval).

<sup>104</sup> Venture-backed software firms rank “patents” on average the lowest in importance, but their average ranking is not statistically different than “copyright” and “trademark.” Patenting is statistically different from the next most lowly ranked method, “secrecy,” at the 95% confidence interval.

<sup>105</sup> These included: (1) product innovation; (2) process or internal tools innovation; (3) business-model innovation; and (4) design innovation (including product shape and packaging).

<sup>106</sup> We defined “product innovators” as those that rated product innovation as “very important” but all other types of innovation as less important. Similarly, we defined “process innovators” as those that rated process innovation as “very important” but all other types of innovation as less important.

Our analysis demonstrates that, in general, patenting is much more important for product than for process innovators. In fact, patenting is rated as second only to first-mover advantage by product innovators, but is rated last out of all the methods by process innovators. First-mover advantage, secrecy, copyright, trademark and difficulty of reverse engineering are also rated as more important by product than by process innovators,<sup>107</sup> but not to the same extent as the differential reported in the importance of patenting between the two types of innovators. Specifically, product innovators rate patents almost twice as important as do process innovators. Among all the methods, only complementary assets are ranked (in absolute terms) as a more important appropriability strategy by process innovators when compared to product innovators.<sup>108</sup>

Noting that biotechnology companies rated patenting as more important overall than did software and Internet firms, we also examined product innovators in each of these two technologies. A strong technology effect on the ranking of patents' importance is once again evident: biotechnology product innovators are much more likely to rate patents as important when compared to software product innovators. In fact, among these product-focused biotechnology companies, patenting remains the most important appropriability strategy, while among product-focused software companies, patenting remains rated the least important means of successfully competing. Therefore, we believe that our main findings are driven more by technology differences than the type (i.e., process vs. product) of innovation.<sup>109</sup>

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<sup>107</sup> The differences associated with copyright and trademark are not statistically significant at conventional levels.

<sup>108</sup> And this difference is not statistically significant at conventional levels.

<sup>109</sup> For a more detailed analysis of patenting among the software firms in our sample, and in software startups more generally, see Pamela Samuelson & Stuart Graham, *How Important Are Intellectual Property Rights to Software Entrepreneurs?* (Working paper, mimeo with authors).

*B. Startups Use Multiple Methods to Compete with Technology Innovations*

As was clear in the aggregate statistics we presented earlier, startups across the high-technology landscape are using different methods to compete with their technologies. While patenting is playing a substantial role in all but the software and Internet sector, our industry studies show that startups in all sectors are using other appropriability strategies—possibly in complementary ways. It is noteworthy, however, that software and Internet startups tend to rate all of the methods about which we queried as less important than do companies in other sectors. Software and Internet companies rate on average only one method, first-mover advantage, as at least “moderately important.” Conversely, companies in other industry sectors rate at least three methods on average as more than “moderately important” (Table 1).

Our in-depth interviews with respondents support these observations. One executive at a biotechnology startup with whom we talked—we will call him Glen—reported that the company held over 150 patents, many of which his company filed, but a substantial number of which were acquired from other entities. In describing his company’s competitive strategy, he reported:

We have three tiers when thinking about how to protect our technology with intellectual property. Tier one comprises [our basic technologies]; tier two involves the ‘clumping’ of our [basic technologies]; tier three is a combination [of our technologies] to very specific uses. Beyond these, we adopt different strategies for different products and for different reasons. For one, we file less manufacturing patents in hopes of keeping these as trade secrets.<sup>110</sup>

Glen also related that, while first-mover advantage is a key component of his company’s strategy,

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<sup>110</sup> Interview with anonymous company founder, March 2009.

[first-mover advantage] plays more of a role in the drug industry than it does in biotech . . . . It is also important [for us] to establish relationships within the network of similar companies and investors. Finding key partners is critical for a platform company like us.<sup>111</sup>

These comments reflect several findings that arise from our survey results. While biotechnology firms are active patent-holders and are more likely to say that patents are important to their competitive position, they also tend to rank several, if not all, of the various means of “capturing competitive advantage” from technology more highly relative to software companies. Moreover, to effectively compete with new technology innovations, startups tend to report that multiple methods of appropriability are useful; even though the clustering of and relative importance ascribed to these methods do not follow a common pattern.

For instance, in terms of startups’ use of intellectual property, it is noteworthy that both copyright and trademarks play nuanced roles in terms of gaining competitive advantage from innovation. These forms of protection are particularly salient at software firms, although even in this category there is divergence. Among the “population” of software companies (as proxied by D&B), executives rate “copyright” in the second rank, not statistically different from complementary assets (but both are ranked behind first-mover advantage, which is clearly rated as the most important method).<sup>112</sup> For these same software-firm respondents, trademarks are ranked just behind copyright and complementary assets, and are considered just as important as secrecy in capturing competitive advantage. Among venture-backed software firms, however, trademarks, copyright, and patenting are ranked behind all others, statistically undifferentiated among each other as the least important methods of capturing competitive advantage. The

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<sup>111</sup> *Id.*

<sup>112</sup> Differences significant at the 99% confidence interval.

## *HIGH TECHNOLOGY ENTREPRENEURS AND THE PATENT SYSTEM*

responses of D&B software companies differ markedly not only from venture-backed software firms, but also with all companies in other sectors. Among non-software startups, copyright is rated the least important of the several methods, while trademarks tend to be among the lower-ranked items.

In sum, while we find that various appropriability strategies are important to technology startups, our chief finding is that, in general, patenting plays a substantial role in helping early-stage technology companies compete. But having learned that patenting is “important” in securing competitive advantage does answer for us the question: What are the specific mechanisms by which this “competitive advantage” is achieved? Is competitive advantage at the level of the startup attained through added financing that patents help facilitate for the company, thus enabling it to develop a better technology and get it to market faster and more effectively than its competitors? Or is this competitive advantage won when a patent “signals” to suppliers and would-be customers that a company has a valuable and important technology? Or do patents permit the company to secure their innovations, and keep competitors at bay while it develops a monopoly position that patents then serve to protect and solidify? We could answer these questions only by inquiring into the specific factors motivating companies when they choose to seek patent protection on their innovations. As such, we asked of our respondents whom had actually filed at least one US patent about the reasons they pursued a patenting strategy.

V. SECOND FINDING: STARTUPS HAVE DIFFERING MOTIVES FOR PATENTING

We find that when technology entrepreneurs seek patent protection, they often do so for varying and, sometimes, complementary reasons. Comments made by Glen, the CEO of a biotechnology firm holding over 150 patents whom we interviewed, are illustrative:

We have a patent committee that decides, within a complex framework of factors, whether it is important to patent, whether competitors will copy the technology regardless of IP protection, and whether the patent will have foreseeable future value . . . . Patents also tend to legitimate [our product]. A patent can also provide a source of supplementary income and can be a badge, a branding, of a successful innovative high-tech company.

Glen also told us that patents are important to his company when making deals and seeking investment:

When doing deals, sometimes we only show our stack [of patents], and sometimes the other party wants to do a lot of due diligence on our individual patents. But we never fail to give a presentation of about one hour on them—patents play a huge role in securing investment.

He also indicated how the issues of investment, copying, and competition were interrelated in the ways his company approached patenting:

I have fidelity in my investors, and have raised over \$100 million in capital. In securing my investors' support, I see our patent portfolio as an integral piece of the puzzle. Our competitors are concerned about our patents, or otherwise they'd do it themselves. Our customers don't really care—they just want the best product at the cheapest price. But if startups like ours are not diligent about securing patents, they will be crushed by larger corporations, who will steal your technology and make it cheaper—and obliterate you.

This chief executive's comments touch upon several of the factors that our study of the literature and our pre-survey conversations with entrepreneurs and investors suggested as motivators for startups to seek patent protection. During this process we identified those



factors that were most prominent, including: preventing others from copying products or services; improving the chances of securing investment; obtaining licensing revenues; improving the chances/quality of liquidity (e.g., acquisition/IPO); preventing patent infringement actions against the company; improving the company's negotiating position with other companies (for example, cross-licensing); and enhancing the company's reputation/product image. In the survey, we asked whether the company had filed at least one patent, and among those answering in the affirmative, we inquired into the importance of these several motivations for patenting.<sup>113</sup>

*A. Startups File Patents to Prevent Copying, Secure Their Financial Goals, and Enhance Reputation*

Across all respondents, the most important reason for patenting is to prevent others from copying the startup's products and services (Figure 2).<sup>114</sup> Following this reason are clustered improving chances of securing investment; improving chances and quality of a liquidity event (another species of securing capital);<sup>115</sup> and, of somewhat lesser importance, enhancing company reputation and product image.<sup>116</sup> This latter result—in which financial motives dominate reputation—is driven entirely by the *VentureXpert* companies in our survey. When we consider only D&B respondents, enhancing reputation is indistinguishable from securing funding and improving liquidity,

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<sup>113</sup> See also Sichelman & Graham, *supra* note \_\_, which contains a more detailed account of our survey findings on the motivations to patent.

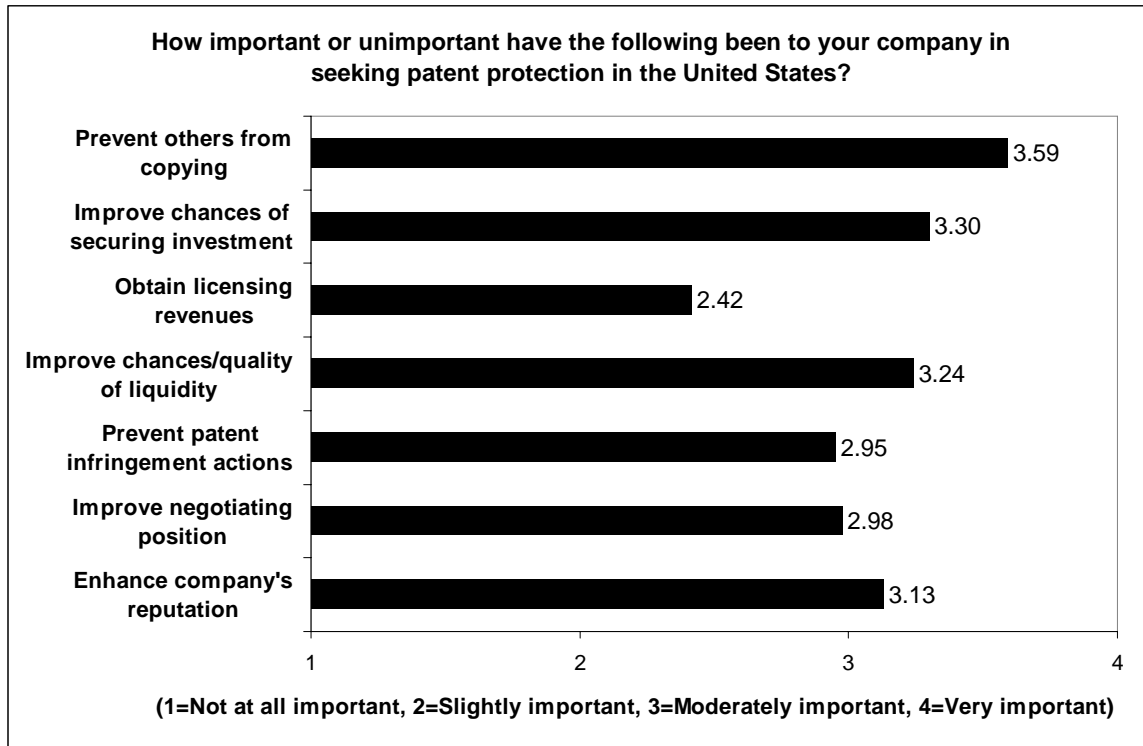
<sup>114</sup> The mean for this response was statistically different from the next most important (securing investment) to a 99% confidence level. When we report confidence levels herein, we describe differences as either at 90%, 95%, or 99% level, but an actual confidence level may be higher than the reported value.

<sup>115</sup> We consider the “liquidity event” here as a means of securing capital for growth. We recognize, of course, that successful exit can also provide a return on investment for financiers and personal wealth for founders and employees.

<sup>116</sup> There were no statistically significant differences between the rankings of securing investment and improving the liquidity event, but enhancing company reputation ranks as significantly different from both of these former reasons at a 95% confidence level.

although among the D&B startups preventing copying is still the most important reason reported for filing patents.

Figure 2: Motivations for Patenting – All Startups Filing Patents



Question asked of those reporting their company had filed for at least one U.S. patent: “How important or unimportant have the following been to your company in seeking patent protection in the United States?” (Averages reported).

These results contrast with earlier large-firm surveys in which respondents ranked patenting for securing capital as relatively unimportant.<sup>117</sup> Our results are consistent, however, with a finding reported showing that smaller firms tend to rank the importance of patenting to enhance firm reputation as significantly higher than do larger firms.<sup>118</sup>

<sup>117</sup> There is a slightly stronger tendency by the venture-backed firms to rate improving the chances of securing investment and liquidity events as more important than the D&B firms. However, the order of the reasons listed is the same for each sample set as the aggregate presented above.

<sup>118</sup> See Cohen, et al, *supra* note \_\_ at \_\_.

Our findings are also consistent with studies by other social scientists showing that patenting plays a positive role in valuation during fundraising and upon exit.<sup>119</sup>

The qualitative interviews we conducted with respondents following the administration of our survey add flavor to these findings. Patenting to prevent copying was an important motivator for the CEO of a software firm whom we call Anna. She created a piece of software, and filed a patent, prior to founding a startup to market the software in 2003. That patent became important to her company's survival and success.

Anna relates:

A large public company copied the code of our product and tried to sell it on the market [] . . . . Without my patent, I wouldn't have been able to stop it. . . . [Ultimately], our company settled on the courthouse steps—literally—and we got our expenses covered, picked up a bit of money, and also established a license agreement [with the large company] to license it and pay us royalties.

Regarding the relationship of patenting to entrepreneurial capital, she remarked:

Venture capital investors place a high value on companies with patents. From 2003 through 2007, I sat in on many startup and venture capital boards and, generally speaking, I found that patents were key to funding—in fact, they were the differentiator between companies.

These comments mirror our general findings that motivations to patent are varied, but that “prevention of copying” and “financing and reputation” motives loom large for startups.

The next most important reasons for technology startups to file patents deal with defensive and, possibly, strategic motives—namely, to prevent infringement lawsuits and to improve negotiating, such as for cross-licensing (Figure 2).<sup>120</sup> We are unable to

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<sup>119</sup> See Hsu & Ziedonis, *supra* note \_\_ at \_\_; Cockburn & MacGarvie, *supra* note \_\_ at \_\_.

<sup>120</sup> While the means of both of these motivations are significantly different at the 99% confidence level from that of “enhancing reputation,” there are no statistically significant differences between the two reasons. Taking the lesser important reason of this group—preventing patent actions against us—there was

differentiate, however, whether the “negotiation” value of patents is related to strategic motives or reflects the “deal making” aspects of financing and the exit event mentioned earlier.

That startup and early-stage firms rate these motives for patenting as “moderately important” is a novel finding, insofar as previous work had implicitly assumed—at least outside of the biotechnology industry—that these firms were not targeted in enforcement (litigation and licensing) activity at sufficiently high rates to justify using patents defensively.<sup>121</sup> Although it appears that our early-stage technology firms report that these motives for patenting are less important than do firms surveyed in earlier large-firm surveys,<sup>122</sup> our result that startup firms may be engaging in sophisticated uses of patents for strategic and defensive purposes is nonetheless noteworthy and deserves further study.

Finally, among all startups, the importance of securing licensing revenue was rated significantly lower than other reasons, falling between “slightly important” and “moderately important” at the mean of all respondents. This finding might seem to conflict with the notion that small firms are more likely to license their patents, consistent with the markets-for-technology view that vertical specialization allows small firms to operate in the upstream technology markets and provide technology inputs to (generally large) firms operating in the downstream product markets.<sup>123</sup> Indeed, a recent survey of European patentees showed that small firms are much more likely to patent to secure

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a statistically significant difference at the 99% confidence level when compared with the next most important reason—licensing.

<sup>121</sup> See Graham & Sichelman, *supra* note \_\_, at 1096 (“We would be somewhat surprised if many start-ups are filing for patents to improve their position in cross-licensing negotiations . . .”).

<sup>122</sup> See Cohen, et al, *supra* note \_\_ at \_\_; Levin, et al, *supra* note \_\_ at \_\_.

<sup>123</sup> See, e.g., See Arora & Ceccagnoli, *supra* note \_\_, at \_\_.

licensing revenue than larger ones.<sup>124</sup> While our main findings show that licensing revenue is, in general, a comparatively unimportant consideration in startup patenting, some evidence from our study supports the view that the smallest of startup firms rely more on “patenting for licensing” than do larger ones.<sup>125</sup> And as we detail in the next section, firms in the biotechnology industry—which is often used as an exemplar of vertical specialization—are more likely to rate licensing income as an important reason to patent than are firms in other sectors we surveyed.

*B. Startups’ Motivations to Seek Patents Differ by Industry*

Consistent with the anecdotes we collected during our qualitative interviews, our results also show significant inter-industry differences in the motives for filing patents (Figure 3). We find that the health and life science companies (biotechnology and medical devices) tend to cluster in the importance they ascribe to the different motives. From a statistical standpoint, the averages presented in Figure 3 are indistinguishable as regards the biotechnology and medical device respondents, with the exception of “obtaining licensing revenues” and “improving negotiating position,” which biotechnology firms rate as significantly more important motivations to file patents.<sup>126</sup> Highlighting the industry distinctions, software and Internet firms’ answers are all significantly different from the biotechnology and medical device firms, with the exception of “preventing patent infringement actions.”<sup>127</sup>

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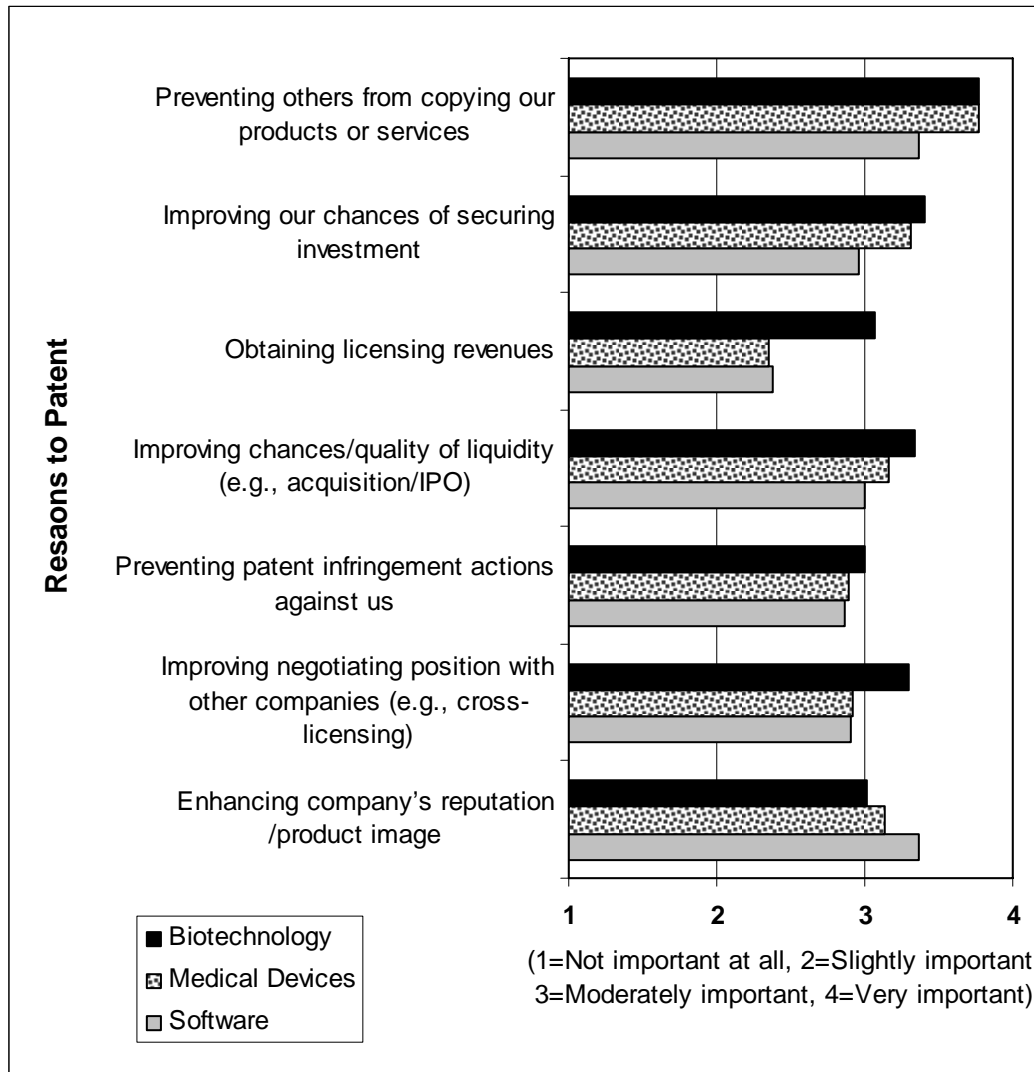
<sup>124</sup> See See Alfonso Gambardella et al., *The Value Of European Patents: Evidence From A Survey Of European Inventors* 21 (2005), available at <http://www.alfonsogambardella.it/PATVALFinalReport.pdf>.

<sup>125</sup> When we segment our respondent firms by total revenue, high-revenue entrepreneurial firms report that licensing is significantly less important to patenting than for low-revenue ones. See Sichelman & Graham, *supra* note \_\_\_\_.

<sup>126</sup> These differences are significant at the 99% and 95% level of confidence, respectively.

<sup>127</sup> These difference are significant at the 95% confidence interval or above.

Figure 3: Motivations for Seeking Patent Protection, by D&B Industry



Question asked of those reporting their company had filed for at least one U.S. patent: “How important or unimportant have the following been to your company in seeking patent protection in the United States?” (averages reported).

In particular, biotechnology and medical device firms list preventing copying as nearly “very important” overall, while software firms place less emphasis on this motive (though still rating it between “moderately” and “very” important).<sup>128</sup> The biotechnology and medical device companies also cite patenting to secure investment and to improve

<sup>128</sup> Biotechnology and medical device firms showed statistically significant differences in their mean responses for the importance of preventing copying from hardware and software firms at a 99% confidence level.

the chances and quality of a liquidity event as much more important motivations than do software firms.<sup>129</sup> Finally, biotechnology firms place much greater emphasis on patenting to obtain licensing revenue than all other firms, including medical device firms.<sup>130</sup>

*C. Patents Serve an Important Function in Startups' Securing Capital*

An important finding of our study is that patents play an important role in the financing of startup companies, both during the initial stages and subsequent development of the firm, and also at the liquidity or “exit event.” Entrepreneurs and startup firms, largely due to their small size and limited experience, can face substantial barriers when seeking to secure the financial resources necessary to grow and to survive.<sup>131</sup> Startups can lack observable measures of success since they generally have few assets and little to no operating history.<sup>132</sup> The uncertainty that this limited information creates makes it difficult for potential startup investors to appraise the quality and profit potential of the enterprise and, as a result, these investors must assess the value of startups through other readily available measures.<sup>133</sup>

Several commentators have suggested that patents can serve as “quality signals” for startup investors.<sup>134</sup> David Hsu and Rosemarie Ziedonis, for instance, have

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<sup>129</sup> Biotechnology and medical device firms showed statistically significant differences from hardware and software firms at a 99% confidence level.

<sup>130</sup> Biotechnology firms showed statistically significant differences from medical device, hardware, and software firms at a 99% confidence level.

<sup>131</sup> See A.L. Stinchcombe, A. L., *Social Structure and Organizations*, in HANDBOOK OF ORGANIZATIONS 142-193 (J.G. March ed., 1965).

<sup>132</sup> See T.T. Tyebjee & A.V. Bruno, *A Model of Venture Capitalist Investment Activity*, 30 MGMT. SCI., 1051 (1984).

<sup>133</sup> See T.E. Stuart et al., *Interorganizational Endorsements and the Performance of Entrepreneurial Ventures*, 44 ADMIN.SCI. Q. 315 (1999).

<sup>134</sup> David Hsu & Rosemarie Ziedonis, *Patents as Quality Signals for Entrepreneurial Ventures* (Apr. 2007) (unpublished manuscript, on file with Mack Ctr. for Technological Innovation working paper series) available at

recognized that many characteristics of the firm can be used as quality signals associated with future profits, but that patents in particular have been underappreciated in that role in the prior literature.<sup>135</sup> Moreover, patents are costly assets, and therefore fit the cost criteria for a quality signal laid out by Michael Spence, who suggested that, to be credible, a signal ought to be costly, both in terms of direct pecuniary costs and effort.<sup>136</sup>

While these theories can be read to apply to many types of investment, existing empirical tests of the value of patents tended to examine only venture capital, a species of investment that comprises a relatively small slice of the overall entrepreneurial finance pie. In contrast to relatively difficult-to-secure venture capital financing, startups are more often funded by angel investors and commercial banks, and most often by “friends and family.”<sup>137</sup> The Kauffman Foundation Firm Survey, which tracks a cohort of companies founded in 2004, shows that while 1% and 5% of companies started in their founding year by exchanging ownership in the company for venture-capital and angel funding, respectively, 7% took personal loans from “friends and family,” 13% supported the founding with personal loans, and 39% used personal credit cards to finance at least some part of the startup.<sup>138</sup>

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[http://elsa.berkeley.edu/~bhall/e222spring07\\_files/HsuZiedonis07\\_PatentSignaling\\_abstables.pdf](http://elsa.berkeley.edu/~bhall/e222spring07_files/HsuZiedonis07_PatentSignaling_abstables.pdf) (suggesting that entrepreneurial lineage, founder backgrounds, and affiliations with reputable third parties such as corporate partners, venture capitalists, and investment bankers, can serve as important quality signals); Long, *supra* note \_\_ (setting forth a “signaling” theory of patents).

<sup>135</sup> Hsu & Ziedonis, *supra* note \_\_.

<sup>136</sup> Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

<sup>137</sup> Alicia Robb & David T. Robinson, *The Capital Structure Decisions of New Firms* (Feb. 11, 2009), available at <http://ssrn.com/abstract=1345895>.

<sup>138</sup> David DesRoches, Alicia Robb & Timothy M. Mulcahy, *Kauffman Firm Survey (KFS) - Baseline/First/Second Follow-Ups: Study Metadata Documentation* (Apr. 27, 2009), available at <http://ssrn.com/abstract=1024312>.



1. Investors and Entrepreneurs Highlight the Role of Patents in Startup Financing

Unlike previous studies, our survey examined various sources of startup investment, and the results show that patenting plays a more substantial role than has been commonly believed in supporting many different species of entrepreneurial capital investment. Several of the qualitative interviews we conducted with our respondents support this finding. For instance, the venture-firm partner Stan, who works with a venture capital firm and invests primarily in life-science companies, told us:

When thinking about the life-cycle of a company, in many respects the value of the IP is really generally assessed at the early stage by the first stages of ‘professional’ money. These early-stage [professional investors] will do a great deal of scrutiny of IP of all types, but especially of trade secrets and patents. If you think about a patent estate as having a life, most of its validity is presumably established when the first guys do their investment. Later investors experience less need to invest as much effort into due diligence as the early-stage investors did – there’s generally no need to go back and repeat what’s already been done. What will happen is that later investors will look at marginal change in the patents of a company since the last investigation. . . . A reason why patents are so important in the biotechnology industry in particular is that, when one makes a biotech investment, fundamentally one is making an IP investment. Consequentially, the early-stage venture investors dig very deeply into the validity of that IP.<sup>139</sup>

These comments resonate with our empirical findings; that investors of many types value patents as an input into their investment decision—but particularly venture investors, and particularly in the life sciences.

Startup executives whom we interviewed also remarked about the importance that patents play in convincing investors to fund the startup. Neil, the CEO of a biometrics information company, suggested to us that:

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<sup>139</sup> Interview with anonymous partner, May 2009.

[I]nvestors were interested in patents, and it was a key question that came up during negotiations. But our company does not hold patents as their core investment—instead we focus on our services to earn revenues.<sup>140</sup>

This latter statement by Neil shows that there remains some ambiguity about patents' usefulness in securing funding. Even among those companies that hold patents, we found similar ambiguity. For instance, our interview with Jeremy, the sole proprietor of a medical device company who filed one patent, yielded this comment:

I applied for a patent to make it clear to investors what exactly it was that I owned. But seeing [the device] live is better than reading a patent, and I think that a live demonstration of [my device] is better in securing their investment.<sup>141</sup>

These comments from technology entrepreneurs are instructive, and help to highlight two important findings of our survey. First, patents appear to be playing a significant role in the funding decisions of many different types of startup investors. But second, patenting may not be a necessary condition for access to entrepreneurial capital.

## 2. The (Sometimes) Role of Patents in Attracting Entrepreneurial Capital

Our survey specifically asked respondents about the role that patents play in securing investment from six different sources: friends and family; angel investors; venture capital investors; other companies as investors (corporate venture capital); investment banks; and commercial banks (such as credit and/or loans). We inquired of our respondents whether the company had had negotiations with any of these six sources of startup capital and whether the company had been funded by that source. Moreover,

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<sup>140</sup> Interview with anonymous executive, March 2009.

<sup>141</sup> Interview with anonymous founder, February 2009.

we asked respondents to report whether each of the funding sources had indicated that the startup having patents was an important factor in that source's funding decision.<sup>142</sup>

a. Technology Startups' Funding Originates from Several Sources

Our results document that funding for high technology ventures is coming from various sources. Among D&B companies, slightly more than half (55%) indicated that friends and family had funded the company. This share is slightly lower for software firms (52%) and slightly higher for biotechnology companies (61%). The share of all venture-backed firms reporting funding by "friends and family" is lower still at 45%.<sup>143</sup>

Commercial banks (credit/loans) were also significant sources of funding for startup ventures. Just under one third of both D&B (30%) and venture-backed (29%) respondents indicated that a commercial bank had funded them. Among the D&B companies, slightly more than a third (34%) of software firms had been funded by commercial banks, while only 17% of biotechnology firms said they had received commercial-bank funding. This finding suggests that credit and loans remain significant sources of startup funds, even among the high technology startups we studied.

Startup executives also told us that both venture-capital and angel investors play a significant role in funding new technology ventures. Among D&B companies, less than one fifth (18%) report securing venture-capital funding, while one quarter (25%) are funded by angel investors. Among the biotechnology firms, the share securing investment is higher, with just under one quarter (24%) receiving venture-capital funding,

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<sup>142</sup> We understood that, like the problem of "hearsay," relying on one person's interpretation of the beliefs of another can be a problematic approach. In an attempt to mitigate against this problem, we asked the respondent whether the source had "indicated" that patents were an important factor.

<sup>143</sup> Our questionnaire did not ask about how many different times the respondent company may have negotiated with a source. Therefore, we have no way of knowing for certain how a respondent would answer our funding questions if they had had multiple negotiations with a source, and had been successful in attracting funding from some, but not others. A strict reading of our questions, however, would lead a respondent to answer "yes" to negotiation and "yes" to funding in that circumstance.

and over one third (34%) securing angel funding. For the venture-backed sample, these figures balloon substantially: 88% of companies report receiving venture capital funding, while 54% answer that at least one angel investor funded the company.<sup>144</sup>

In terms of startups reporting a funding event, “other companies” as investors and investment banks were the least relevant sources. Other companies as investors were cited as a source of funding by D&B companies in 15% of cases, while investment banks funded just 4% of these firms. These figures were higher among the venture-backed sample, with just over one quarter (28%) reporting that other companies had invested in the startup, while 14% of the venture-backed companies reported that investment banks had funded them.

b. Startups Report that Patents are Important to Their Investors

In addition to disclosing that funding comes from divergent sources, our respondents report that patenting plays a more significant role in attracting funding than had been previously believed. It is widely held that venture-capital investors rely on patents in their investment decisions, although the reason for this reliance is unclear. Some suggest that the patent is an important “signal” of quality in an uncertain investment environment, and that by relying on the independent expertise of the patent office the investor can dispel some of the information asymmetries between the investor and the startup.<sup>145</sup> An alternative explanation says that patents are considered a prerequisite for the startup venture, giving the company sufficient “freedom to innovate” and allowing the firm to develop its embryonic product toward the market. Another

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<sup>144</sup> It may seem curious that, among the venture-backed VentureXpert sample that some companies report having no “venture-capital” funding—we interpret this outcome as interpretations by the respondent about what types of investment fall into the categories “venture-capital,” “angel,” “investment bank,” or “corporate venture capital” funding.

<sup>145</sup> See Hsu & Ziedonis, *supra* note \_\_; Long, *supra* note \_\_.

theory suggests that investors require the companies to have patents so as to enjoy these IP rights (IPRs) as residual claimants should the venture fail.

While our data does not shed light on these different explanations *per se*, we are able to report some results on the perceived importance of patents in startup funding.<sup>146</sup> Our figures reflect the share of those respondents who reported that a potential funding source (e.g. “friends and family”) with whom the respondent negotiated had indicated that having patents was important to their funding decision. For D&B companies that negotiated with venture capital funders, just over two-thirds (67%) reported that patents were an important factor. This share is higher among our venture-backed sample, with just above three-quarters (76%) indicating as much. There are also notable technology differences: Among the D&B companies, 60% of software firms reported that venture capital investors considered patents important,<sup>147</sup> while that figure rose to 73% for D&B biotechnology firms and 85% for D&B medical device companies.

Surprisingly, respondents reported that patents are also important to many commercial banks and “friends and family” investors. In our D&B sample, companies negotiating with “friends and family” declare that 31% consider patenting important to making a funding decision. For those D&B companies negotiating with commercial banks for loans or credit, the figure is just over one fifth (21%). The shares reported by the venture-backed sample are similar for “friends and family” (35%), but increase markedly for commercial banks—among venture-backed firms, nearly half (49%) said

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<sup>146</sup> In fact, the importance associated with “enhancing reputation” among the startups that filed at least one patent may be reflecting, at least in part, a desire by the company to become more attractive to investors.

<sup>147</sup> For a more detailed discussion of software firms, patenting, and entrepreneurial finance, see Samuelson & Graham, *supra* note \_\_\_\_.

that commercial banks with whom they negotiated indicated that patenting was important to extending credit or loans.<sup>148</sup>

Our respondents also indicated that patents are important to other sources of entrepreneurial capital. D&B companies report that 57% of angel investors, 54% of “other companies” as investors, and 50% of investment bankers with whom they negotiated indicated that patents were important to their investment decision. Among our venture-backed sample, the figure for angel investors is similar to that for D&B firms (59%), but patents were reported to be significantly more important to investment banks (61%) and “other companies” as investors (70%) than was the case in the D&B sample.<sup>149</sup>

c. Patents’ Reported Importance to Investors Differs by Industry

As with other aspects of patenting by startups, we found interesting industry differences in the reported importance of patents to investors. Among D&B biotechnology firms, for instance, respondents were much more likely to reveal that commercial banks considered patenting by the target firm important (43%) as compared to D&B software firms’ respondents (13%). This difference is also notable among “friends and family” funders, reported to consider patents as important for more than half (55%) of D&B biotechnology firms, but for less than one quarter (23%) of D&B software companies. There are also significant differences when respondents report upon angel investors (71% for biotechnology and 53% for software), venture-capital (73% and 60%, respectively), “other companies” as investors (64% and 42%, respectively), and

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<sup>148</sup> This finding on the importance of patents to commercial banks among venture-backed firms may be including so-called “venture debt.” See Darian M. Ibrahim, *Debt as Venture Capital*, University of Wisconsin Legal Studies Research Paper No. 1081, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1418148](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418148).

<sup>149</sup> These differences are significant at the 90% and 99% confidence interval, respectively.

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investment banks (62% and 36%, respectively). Clearly, across all funding sources, respondents declare that patenting is seen as much less important to secure the investments for software as compared to biotechnology companies.

These industry differences are also marked in our venture-backed sample. Among the venture-backed biotechnology firms, for instance, “friends and family” were much more apt to indicate that patenting by the company seeking funding was important (61%) than among venture-backed software firms (18%). This difference is also notable in the responses concerning commercial banks, with companies reporting that “friends and family” indicated patenting as being important for almost three quarters (74%) of venture-backed biotechnology firms, but for less than one third (31%) of venture-backed software companies. There are also significant differences among angel investors (78% for biotechnology and 36% for software), venture-capital (97% and 59%, respectively), “other companies” as investors (90% and 51%, respectively), and investment banks (81% and 40%, respectively). As with the D&B companies, across all funding sources, patenting is seen as much less important to secure the investments in software than in biotechnology companies when the respondent comes from a firm that is venture-backed.

In sum, our survey respondents report that patents are being widely demanded by different sources of entrepreneurial capital; but that demand does not extend to all funding negotiations, and in fact the incidence of interest by different funding sources is highly variable. While a caveat is in order—that these findings are based upon the perceptions of the recipient about what was in the mind of the investor—the executives of the startups were nevertheless privy to negotiations and can be expected to have unique insights into what occurred during their funding negotiations, and what documents and

information were requested of their companies. We are therefore reasonably confident that our data present at least a proximate window into the importance of patenting to startup investors.<sup>150</sup>

#### VI. THIRD FINDING: TECHNOLOGY ENTREPRENEURS HAVE VARIOUS REASONS NOT TO SEEK PATENTS

There are many reasons why companies may choose not to patent their major technology innovations.<sup>151</sup> Patenting is sometimes viewed by the academy as a “substitute” for secrecy, the former tending to vitiate any long-term attempts at secrecy through its disclosure requirements.<sup>152</sup> There are several reasons for startup firms opting against patent protection, including the belief that the technology is not patentable; the high costs associated with prosecuting and enforcing the patent; the perception that, with reverse engineering, that patents may afford relatively weak protection; the fear of disclosure; and the availability of other forms of protection.<sup>153</sup>

Rather than simply asking of our respondents that hold no patents to report on their motivations for choosing against patenting, we wanted to uncover possible strategic decision about patenting by those companies that *had chosen* to hold patents. Therefore, our survey instrument directed our respondents to consider the last major technology

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<sup>150</sup> In fact, our numbers may be biased downward: investors may have more reasons to *not* disclose that they are interested in seeing a firm’s patenting than they have for *misrepresenting* that they want to see them in negotiations, when in fact they do not care about them.

<sup>151</sup> For more analysis, see Sichelman & Graham, *supra* note \_\_, which contains a more detailed discussion of our results on why startups choose not to patent their inventions.

<sup>152</sup> See David D. Friedman, William M. Landes & Richard A. Posner, *Some Economics of Trade Secret Law*, 5 J. ECON. PERSP. 61 (1991). *But cf.* Stuart Graham & Deepak Somaya, *Vermeers and Rembrandts in the Same Attic: Complementarity between Copyright and Trademark Leveraging Strategies in Software* (Ga. Tech. TIGER Working Paper, Feb. 23, 2006), available at <http://ssrn.com/abstract=887484> (suggesting that a complements view is more appropriate when viewing IP protection at the level of the innovation or the firm).

<sup>153</sup> See Graham & Sichelman, *supra* note \_\_.



innovation that they did not patent, irrespective of whether the company held patents or not. Each respondent was asked whether that last innovation was a product or a process (or not), and what reasons motivated their company's decision not to patent.

Our study of the literature and previous surveys, as well as discussions with entrepreneurs and investors, allowed us to generate a list of the most common reasons why, reportedly, startups chose not to patent their innovations. The survey included: did not want to disclose information; cost of getting the patent, including attorneys' fees; competitors could have easily invented around the patent; believed that trade secret was adequate protection; cost of enforcing the patent, including actions in court; did not believe the technology was patentable; and no need for legal protection.<sup>154</sup> By constructing our questionnaire in this manner, we were able to collect information on what is essentially a sample of recently un-patented major technologies generated by startup companies.

*A. Cost Considerations Loom Large for Startups in Deciding to Forgo Patenting*

We find that, among technology startups, the cost of getting a patent is the most common reason cited for not patenting a major technology. Figure 4 shows the shares of respondents responding to motivation for not patenting their company's last major technology innovation.<sup>155</sup> Cost considerations in patenting loom large for startups, with the cost of prosecuting and the cost of enforcing the patent cited by more respondents than any other reason. These motivations are followed closely by the ease of inventing

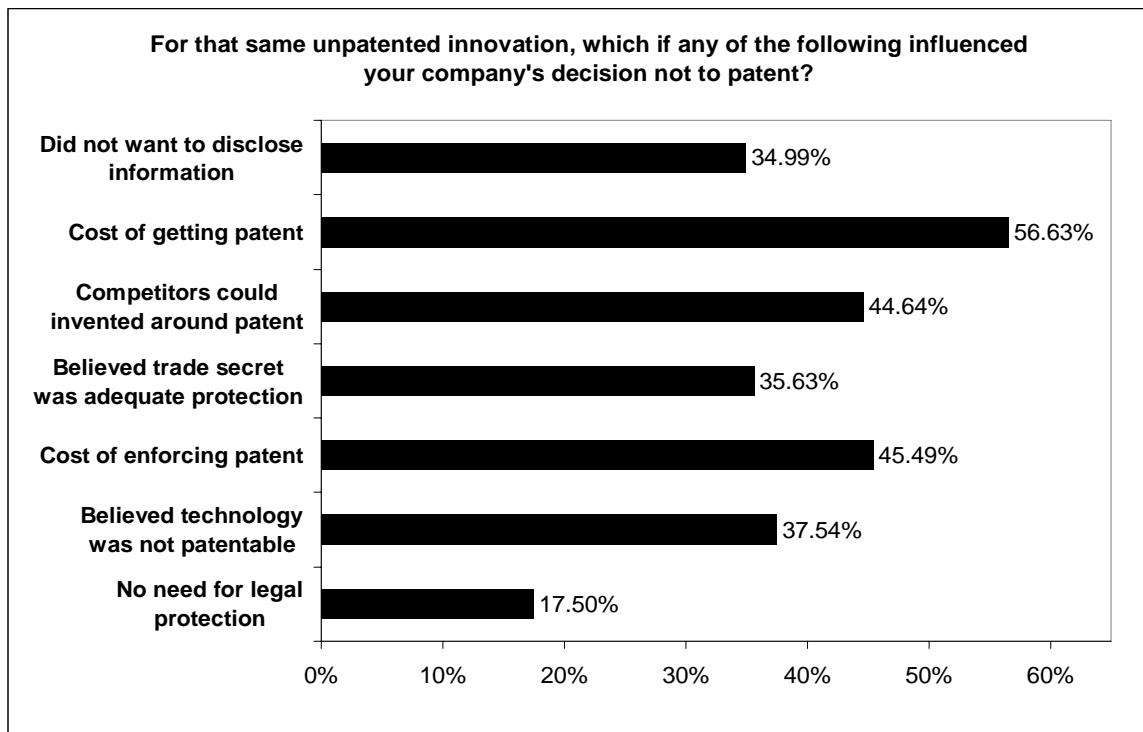
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<sup>154</sup> Our questionnaire allowed respondents to indicate multiple reasons. In a follow-on question, we asked our respondents to report which of these motivations was the most important reason.

<sup>155</sup> This question could be answered by respondents regardless of whether they had filed for a patent. Because respondents could check one or more of these selections, the percentages for each reason do not add up to 100%.

around the patent.<sup>156</sup> These results are similar to those found in a Small Business Administration survey conducted in 1998 of small firms, which listed these same reasons at the top of small-business motivations for forgoing patenting.<sup>157</sup> In contrast, the difficulties and costs of acquiring and enforcing patents tended not to be salient for respondents in previous large-firm surveys. Yet, these same studies show that even in the large firm surveys, relatively smaller firms tend to report a significantly higher sensitivity to the costs of filing and enforcing patents.<sup>158</sup>

Figure 4: Reasons for Startups to Forgo Patent Protection on Major Technologies



Question: “Thinking about the last major technology innovation that your company did not patent . . . which if any of the following influenced your company’s decision not to patent? (Please check ALL that apply)?” (Share of respondents indicating that the option influenced the decision is reported).

<sup>156</sup> The difference between the reported percentage for the costs of acquiring and the costs of enforcing the patent was statistically significant at a 99% confidence level. The costs of enforcing the patent and the ease of inventing around the patent did not show statistically significant differences from one another, but they were statistically significantly different from the next reported reason to a 99% confidence level.

<sup>157</sup> See Joseph J. Cordes, Henry R. Hertzfeld & Nicholas S. Vonortas, A Survey of High Technology Firms 55-58 (Feb. 1999), available at <http://sba.gov/advo/research/rs189tot.pdf>.

<sup>158</sup> See Cohen et al., *supra* note 21.

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Other evidence from our survey results indicate that the greater sensitivity of smaller firms to costs is not merely due to capital constraints. Another of our survey questions revealed that the average out-of-pocket cost for a respondent firm to acquire its most recent patent was over \$38,000.<sup>159</sup> This figure is significantly higher than the averages for patent prosecution reported in the literature, which vary from a low of \$10,000 to a high of \$30,000.<sup>160</sup> In one of the unstructured hour-long interviews we conducted with respondents, one executive at a venture-backed semiconductor firm stated that startups often pay significantly more than incumbents to their prosecuting attorneys, because startups (1) tend to file for patents on inventions that are more important to the company's core business model than large firms, (2) usually use outside instead of in-house counsel for patent prosecution; and (3) often have difficulty monitoring outside counsel to limit overall costs.<sup>161</sup> Indeed, a non-trivial percentage of our respondents—about 10%—listed cost as the only barrier to filing for a patent from among the options we offered. Additionally, when asked to indicate the “most important” reason for not filing, more than one-third of the respondents selected either the cost of acquiring or enforcing the patent.<sup>162</sup>

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<sup>159</sup> We asked this question only of those respondents who reported that their company had both filed and been granted a U.S. patent.

<sup>160</sup> See Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. U. L. REV. 1495, 1498-99 (2001) (estimating the cost of prosecuting a patent to issuance as between \$10,000 and \$30,000); American Intellectual Property Law Association, 2007 REPORT OF THE ECONOMIC SURVEY 78-81 (reporting average attorneys' fees for prosecuting an original patent application, filing one amendment, and issuing an allowed application as between \$10,000 and \$20,000, depending on the complexity of the technology).

<sup>161</sup> Interview with Executive at Semiconductor Company (Feb. 20, 2009). (In accordance with our human subjects protocol for the survey, we agreed not to disclose the identities of our interviewees without their express permission.)

<sup>162</sup> Specifically, respondents identified the following as the most important reasons for not patenting their last innovation: cost of acquiring the patent (26.00%); did not believe technology was patentable (20.92%); did not want to disclose information (15.84%); ease of inventing around the patent (12.41%); cost of enforcing the patent (10.52%); no need for legal protection (7.33%); and believed that trade secret protection was adequate (6.97%).

Fewer, but nevertheless a substantial number, of respondents also reported that their firms did not seek patent protection because they considered that the innovation was not patentable, believed that trade secret protection was adequate protection, or were reluctant to disclose information.<sup>163</sup> These last two reasons, in fact, may be complementary, and may be associated with the cost considerations cited earlier. The relative infrequency of startups citing these reasons tends to track the responses by large firms in other surveys, although the reluctance to disclose information appears to be, generally, more of a deterrent for large firms than for our early-stage respondents. Part of this difference reflects our survey's heavy focus on software firms, for which a reluctance to disclose information was less frequently cited as a reason to forgo patenting as compared with startups in other sectors. Finally, we note that about 18% of our respondents declared, for their last major technology innovation, "no need for legal protection" as a motive for not filing a patent.

*B. Startups' Reasons to Forgo Patenting Differ by Industry*

A major finding of our study is that the most important reason that biotechnology companies cited for not patenting was a reluctance to disclose information, while software companies most commonly cited prosecution costs as the most important motive for failing to seek patent protection.

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<sup>163</sup> The responses for these reasons were not statistically significantly different from one another, but they were from the next reason—no need for legal protection—to a 99% confidence level.

Table 2: Reasons for not seeking patent protection – Selected Industries

<b>Reason</b>	<b>Category</b>	<b>All respondents</b>	<b>Biotechnology</b>	<b>Software</b>	<b>Difference</b>	<b>Test of difference</b>
Did not want to disclose		35%	59%	25%	+ 34%	**
Cost of filing		55%	43%	64%	- 21%	**
Ease of inventing around		44%	42%	46%	- 4%	
Trade secret was adequate		36%	49%	29%	+ 20%	**
Cost of enforcing		44%	36%	52%	- 16%	**
Did not believe patentable		38%	28%	42%	- 14%	**
Did not need protection		17%	17%	20%	- 3%	
Total responses		1,057	136	589		

Question: “Thinking about the last major technology innovation that your company did not patent ... which if any of the following influenced your company’s decision not to patent?” Differences noted \*\* significant at the 95% confidence intervals. Tests for differences in means were conducted between columns, within rows.

1. Biotechnology Startups Cite Reluctance to Disclose Information Most Commonly as a Reason Not to Patent

In an effort to better understand the drivers of startups’ choices to forgo patenting on their major innovations, we segmented the responses by technology and report the results in Table 2. We find that the most marked divergence occurs between biotechnology and software companies, and we note the differences in the share of companies that reported each motivation, along with statistical significance, in the rightmost column of the table. Biotechnology firms are more than twice as likely to cite “disclosing information” as a reason to forgo patenting as are software firms (59% and 25%, respectively). Biotechnology firms were also more likely to believe that trade secret was an adequate means of protecting their innovations as compared to software

firms (49% and 29%, respectively), although this difference may be a consequence of the differences in the likelihood of an unpatented invention being a process technology, a possibility that we explore below.

## 2. Software and Internet Startups Cite Cost Considerations Most Commonly as a Reason Not to Patent

Costs of patenting and enforcing are cited much more frequently by software and Internet firms as motives for not patenting, a finding that is consistent with the lower significance (as we report above) that software firms ascribe to patents as a means of securing competitive advantage.<sup>164</sup> We note that software firms were also substantially more likely to say that they did not believe that the technology was patentable than were biotechnology companies (42% and 28%, respectively), although we are unsure whether the term “unpatentable” triggered in the respondent a subjective belief about the requirements of the patent laws, or a more philosophical belief about what *ought* to be patentable subject matter.<sup>165</sup>

To add even greater specificity to our results, we asked our respondents to report which of the several reasons for choosing not to patent the technology was their most important reason. The results show that, among all respondents, the cost of filing and the belief that the technology was not patentable are most highly cited (25% and 21%, respectively). As with many of our other results, however, there are substantial industry-specific differences.

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<sup>164</sup> If the asset is considered “less valuable,” sensitivity to cost may be expected to be higher.

<sup>165</sup> See generally Pamela Samuelson & Robert F. J. Glushko, *What the user interface field thinks of the software copyright “look and feel” lawsuits (and what the law ought to do about it)*, ACM SIGCHI Bulletin, v.22 n.2, p.13-17, Oct. 1990.

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Among biotechnology firms, over one third (34%) cite a reluctance to disclose information as the most important consideration, a level that is interestingly nearly matched among venture-backed IT hardware firms (cited by 32%). These industry differences notwithstanding, the cost of filing remains a significant impediment for these startup firms, with greater than 20% of companies in each sector citing this reason as the most important determinant of forgoing patenting on their last unpatented major innovation. This finding adds weight to other results in this survey suggesting that these technology startups are sensitive to the costs of patenting, even when patenting is seen by the executives as an important determinant of commercial and entrepreneurial success.

### *C. Startups' Motives to Forgo Patenting Differ by Innovation Type*

We further explore the differences in the reasons to forgo patenting by determining the most important reason cited by companies according to whether the unpatented innovation was a product or process technology. The results suggest that cost of filing is a particularly salient factor for those companies that chose to forgo patenting on a product technology, with nearly one third of companies (32%) citing this reason as the most important factor. When firms choose to leave process technologies unpatented, they are most likely to cite three reasons about equally: reluctance to disclose information (24%), a belief that the technology was unpatentable (22%), and, again, the cost of filing (21%).

VII. TECHNOLOGY ENTREPRENEURS MUST RECKON WITH PATENTS HELD BY OTHERS

We were not only interested in determining how entrepreneurial companies use (or choose not to use) the patent system, but also how they deal with patents held by others in their market environment. When viewed as barriers to innovation, patents may create a minefield for various innovative activity, from invention, to development, to commercialization. This “minefield” analogy may be particularly relevant in the information technologies, to the extent that these arts are more likely characterized by innovation that is both cumulative (building on earlier generations) and complex (requiring more than one patentable technology for commercialization). Nevertheless, relying on interviews and anecdotes, Ronald Mann has suggested that patents in the competitive environment are often ignored, at least by startup software firms.<sup>166</sup>

Another downside of patents in a startup’s competitive environment is the threat of patent disputes and, when negotiation fails, costly litigation. Startups may be particularly sensitive to accusations of infringement because they are likely to experience resource constraints when faced with the costs of funding a suit, estimated at \$3-5 million per litigant through trial.<sup>167</sup> Suits may come in the form of “bullying” by larger competitors trying to put the startup out of business,<sup>168</sup> or even from “trolls” or non-practicing entities seeking royalty payments. These accusations of infringement are particularly problematical when the underlying patent being wielded against the startup is more likely than not invalid:<sup>169</sup> the resource-constrained startup may find that its least

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<sup>166</sup> Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 TEX. L. REV. 961 (2005).

<sup>167</sup> See AIPLA, *supra* note \_\_, at \_\_.

<sup>168</sup> See Ted Sichelman, *Patent Bullies: How Industry Incumbents Abuse the Patent System* (June 1, 2009) (unpublished manuscript, copy on file with author).

<sup>169</sup> All patents are probabilistic rights until the last court has spoken. See Mark A. Lemley & Carl Shapiro, *Probabilistic Patents*, 19 J. ECON. PERSP. 75 (2005).



costly alternative is simply to pay licensing fees, thus allowing the firm to avoid suffering the huge costs of litigation—even though the patent is on its face invalid. If the litigation is launched by a “bully” attempting to put the company out of business, the suit may have that result if the startup is unable or unwilling to tap the capital markets to fund lengthy and expensive litigation.<sup>170</sup>

But patents in the market environment may be view positively by the startup, too. Patents can serve as mechanisms by which markets for technology may develop, allowing some firms to specialize in a technology-market in a manner analogous to Adam Smith’s division of labor.<sup>171</sup> Patents may therefore serve as a means by which technology, information, or know-how can be more easily transmitted, since there are a host of problems associated with transacting in intangible “knowledge” assets that patents-as-definable-chits helps to solve.<sup>172</sup> Given these discordant but not necessarily mutually exclusive views of the roles played by patents held by others external to the startup, we fashioned a series of questions aimed at better understanding how early-stage companies react to patents in their competitive environment.

*A. Licensing-in Patents: (Some) Startups Licenses from Other Patent-holders*

We were interested in discovering how commonly startups license patents from third parties. Moreover, given the theories explicated above, we wanted to ascertain

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<sup>170</sup> See generally CONSTANCE E. BAGLEY & DAVID LANE, X-IT AND KIDDE (A) (2003), available at [http://cb.hbsp.harvard.edu/cb/web/product\\_detail.seam?R=803041-PDF-ENG](http://cb.hbsp.harvard.edu/cb/web/product_detail.seam?R=803041-PDF-ENG) (detailing a startup’s experience with infringement by a larger competitor, and the difficulty experienced by the startup in securing funding to pursue litigation).

<sup>171</sup> ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776). Instead of some specialized employees in a pin factory making the shafts and others making the heads, the analogy would be that some firms make technology inputs like software while other firms make the technologies to which those inputs are applied, such as hardware.

<sup>172</sup> See Ashish Arora & Robert P. Merges, *Specialized Supply Firms, Property Rights and Firm Boundaries*, 13 INDUSTRIAL & CORPORATE CHANGE 451 (2004).

whether, and under what circumstances, patent licenses were taken to gain technology, information or know-how, or to settle disputes. Among D&B companies, we found that 15% of respondents licensed-in a patent. This figure was significantly higher, over one third (37%), among the venture-backed sample.<sup>173</sup> In addition to these differences among companies based on their funding source, we again find divergence based on the sector in which the company operates: in the D&B sample, biotechnology companies are significantly more likely to license (37%) than are software firms (8%).

### 1. Startups License Both to Gain Knowledge and to Settle Disputes

At least in part, the rationale for having a patent system is that, by offering a limited monopoly on inventions, society will acquire more invention.<sup>174</sup> This property right is limited in both scope and time, with the understanding that, after a period of years, the patented invention will fall into the public domain and be available for all to use. In the meantime, many of the patent law's provisions are tailored so as to require adequate disclosure of the invention, so that other innovators may learn from the disclosure, and possibly improve upon it.<sup>175</sup> The operation of markets for technology are also theorized to help in this "dissemination" function, by relying on the markets to exchange patented knowledge, and thus permit these intangible chunks of creativity to be propertized and transacted upon.

When startup firms reported upon their rationales for licensing others' patents, executives often seek to gain knowledge, information, or know-how in these transactions, but they are often also—and sometimes *only*—seeking to avoid a patent dispute. When

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<sup>173</sup> Difference significant at the 99% confidence interval.

<sup>174</sup> See generally Arrow, *supra* note \_\_\_\_.

<sup>175</sup> See ROBERT P. MERGES, PATENT LAW AND POLICY: CASES AND MATERIALS.

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asked why their company took their last patent license, a majority of all biotechnology company respondents (81%) indicated that they wanted to gain (at least in part) technology, information, or knowhow, while three in ten responded that they licensed-in the last patent (at least in part) to avoid a patent dispute, or for other defensive or “freedom to operate” considerations.<sup>176</sup> Among the (fewer) software firms that took patent licenses, 79% reported doing so at least in part to gain information, technology, or knowhow. Among both the biotechnology and software D&B companies, less than one in ten reported that the only reason they took a patent license was to avoid or settle a patent dispute.

Among the companies receiving venture funding, biotechnology firms were again significantly more likely to in-license a patent (72%) than were software startups (13%). We find that nearly nine in ten of patent-licensing venture-backed biotechnology startups declared that the last patent licensed was taken to gain (at least in part) technology, information, or knowhow. Nearly two in ten of these licenses were taken (at least in part) to settle a dispute. Among the same firms, only 2 of 63 (3%) said that the sole reason they took their last license was to avoid or settle a patent dispute. As such, our results suggest that, on average, early-stage biotechnology companies are not facing demands for licensing payments on patents that are unrelated to technology that they are working upon or can foresee working upon; in general, these firms appear to be taking licenses to patents that bring some knowledge capability into the startup.

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<sup>176</sup> These latter categories were self-defined by the respondents in an “other” category.

## 2. Venture-backed IT Startups Take More Patent Licenses

We uncover that some early-stage IT companies may be more likely to face “nuisance” patent disputes than has been commonly reported. Among the venture-backed information technology companies responding to our questions, nearly four in ten (39%) IT hardware firms (semiconductor, communications, and computer hardware) reported taking a patent license, as compared to just over one in ten (12%) among venture-backed software firms. These patent-licensing IT hardware and software firms are almost equally likely (about seven in ten) to have taken their last patent license to (at least in part) gain technology, information or knowhow.

In a surprising result, both these types of venture-backed IT startups report that, among those that took a patent license, approximately one in four (25% and 22%, respectively) of their last patent licenses were taken to avoid or settle a patent dispute, but *not* to gain technology, information or knowhow. This share is about three times higher than the same figure reported by D&B software companies (8%), and by biotechnology companies regardless of their funding characteristics.

We find this result intriguing—that a quarter of venture-backed information technology firms that have taken patent licenses report that the last license was taken solely to settle a dispute, and not to gain technology, information, or know-how. In fact, these respondents did not suggest any other reasons for taking these licenses.<sup>177</sup> Some caveats are in order, however. While one quarter of venture-backed software firms suggest that ending a dispute was the sole reason for taking their last patent license, the number of firms taking any patent license is quite small (12%). As a result, only 3% of

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<sup>177</sup> Respondents were given the following choices: “For the last patent that your company licenses in, was the license taken (mark all that apply): (a) to gain technology, information, or knowhow; (b) to settle a legal dispute; (c) other [specify].”

all software firms in our sample report taking their last license solely to avoid or settle a patent dispute.

But we can apply the same calculation to the hardware firms in our sample, all of which are venture-backed, and find that nearly four in ten report taking a patent license. This result shows that one in ten (10%) of the venture-backed IT hardware startups take a patent license solely to avoid or to settle a patent dispute. We note that, in contrast to the pattern exhibited by biotechnology firms, these figures associated with settling a patent dispute are much higher for venture-backed IT firms than occurs among their (generally non-venture backed) D&B software counterparts.<sup>178</sup>

What is behind this increased likelihood of venture-backed IT firms facing such litigation? The unstructured hour-long interviews that we conducted with a sample of our respondents produced one story of just such a patent dispute. The executive of a venture-backed IT company in our respondent set informed us that his firm had been the target of a cease-and-desist letter during the company's initial SEC Registration prior to its initial public offering (IPO). He believed the patent was invalid, and that it was simply a nuisance suit aimed specifically at the firm at a time when they were most vulnerable—precisely when the executives were trying to convince investors in their IPO “road show” that the company was a solid investment opportunity.<sup>179</sup>

Anecdotes like this one offer a possible explanation for the pattern that we are finding. That one tenth of venture-backed IT hardware firms may be accepting, and paying royalties, for a patent license that provides no beneficial knowledge or

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<sup>178</sup> This difference between venture-backed and D&B IT company responses is significant at the 95% confidence interval. Statistically, there is no difference between the biotechnology results for the D&B and venture-backed (8% and 4%, respectively).

<sup>179</sup> Interview with anonymous executive, April 2009.

information raises questions about the operation of the “market for patents” as a knowledge exchange mechanism. We surmise that the higher share among IT firms (as compared to biotechnology companies) reporting the taking of patent licenses solely to settle conflicts may be the consequence of several influences: a combination of the type of innovation involved, coupled with the venture-funding event itself.

It is axiomatic that information technologies are different than biochemistry innovations.<sup>180</sup> While these latter are termed “discrete” technologies for which a single patent can often adequately protect the entire invention, the former are characterized as being “complex” technologies in which many separately-patentable inventions are commonly needed to commercialize a product.<sup>181</sup> Complex technologies have been theorized to increase the transaction costs associated with commercialization,<sup>182</sup> and the problems associated with clearing patent rights are well-documented.<sup>183</sup> There are also claims from engineers that, at least in the software arts, many of the patents issued since the 1980s have been on trivial inventions. Patented technology considered trivial coupled with the complex nature of the technology (and a liberal injunction rule) lends itself to hold-up and could result in the pattern we observe.

But a characteristic of these firms—that they are “venture funded”—also appears to be playing a role in this difference. We note that the types of software companies we surveyed from D&B are able to operate generally free of the type claims that appear to be at the heart of our finding. The venture-funding event is an important one in the life of a

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<sup>180</sup> *But see* Arti Rai & James Boyle, *Synthetic Biology: Caught between Property Rights, the Public Domain, and the Commons*. PLOS BIOLOGY 5(3) (2007): e58, available at <http://www.plosbiology.org/article/info:doi/10.1371/journal.pbio.0050058>.

<sup>181</sup> Cohen et al., *supra* note 21.

<sup>182</sup> Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCI. 698 (1998).

<sup>183</sup> *See* JAMES BESSEN & MICHAEL J. MEURER, PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATORS AT RISK \_\_ (2008).

startup, and is often publicized—commonly by the startup itself because it stands as a positive signal of quality to other investors, competitors, and consumers alike. Moreover, commercial research firms (such as Thomson) collect and report on these investments. Therefore, a startup’s venture-funding event is news, and it may raise the profile of the company sufficiently to make it a target for “holdup” of the type we describe above. Companies that are venture funded are also more likely to have other significant “liquidity” events like IPOs or high-value acquisitions and mergers: these two may be increasing the potential “pay off” to patent holders external to the firm when threatening these startups with infringement.

*B. Checking the Patent Literature by Startups: Mixed Findings*

Another little-understood aspect of operating in an environment with patents concerns the propensity, and timing, of patent searching by innovators. When we consider the goals of the innovator and society, there are substantial benefits that flow from searching the patent literature. Because innovation is often cumulative (i.e., it builds upon earlier creations), the cost of innovation for both the innovator and society in the aggregate may be reduced when greater information about the current state of the technology is easily discoverable by the innovator. Moreover, to the extent that the underlying subject matter is a complex technology that is “modular,” searching the patent literature may allow innovators to find existing “inputs” to its ongoing creative process, thus preventing duplicate innovation that tends to squander society’s resources.<sup>184</sup> By searching the patent literature, innovators may also avoid the risk of investing in R&D *ex*

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<sup>184</sup> We speak here of duplicate efforts on the same composition, method, or process—it may be that different means could be used to reach the same outcome.

*ante* only to discover that they cannot practice the inventions *ex post* due to existing and blocking patent rights.

While these benefits suggest that searching the patent literature may be efficient and desirable, it has been suggested that, because of the operation of the patent laws, entities may shy away from actually conducting searches. The existing patent system may have unintentionally created disincentives to patent searching, because doing so would expose the searcher to the risk of being found a “willful infringer.” Under the existing patent laws, entities that are aware of existing patent rights and engage in willful infringement open themselves up to treble damages—a rule that leads to some suggesting that firms should not do searches at all. Moreover, search may be expensive (in both money and time), and in new and embryonic technology areas—or ones that are very general in application—there may be added difficulty in discovering the proper scope for patent searching.

Recent evidence suggests that venture-backed software companies in general not do patent searches.<sup>185</sup> We stress, however, that early-stage entrepreneurs may have only limited access to legal advice, and may be themselves unaware of these rules concerning “willful infringement.” The extent to which the disincentives of this rule are “filtering down” to technology entrepreneurs must remain mere speculation at this point.

We were nevertheless interested in discovering which way these conflicting incentives might cut. We therefore inquired of our respondents whether their company regularly checked the patent literature to determine if someone else has a U.S. patent that covered what they were doing, or what they were considering doing. For those respondents answering “yes,” we also asked at what stage of product / process

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<sup>185</sup> See Ronald Mann, *supra* note \_\_\_ at \_\_\_.



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commercialization the company usually conducted that search: prior to design; during design and development; after launch; or (notably out of temporal order) only when the firm was planning to apply for a patent.

A substantial share of the respondents to this question reported regularly doing patent searches. Among D&B respondents who answered, slightly more than one third reported conducting these searches. This likelihood was particularly high for biotechnology (nearly seven in ten) and medical device (over half) companies, while slightly less than one quarter of software companies reported doing regular patent searches.

Among the venture-backed sample, searching was substantially more common. Among all the respondents to this question, nearly six in ten venture-backed firms reported that they regularly searched the patent literature. Again, this propensity was particularly high among biotechnology (nearly nine in ten) and medical device (over nine in ten) firms. Nevertheless, nearly three in ten venture-backed software startups and over six in ten similarly-funded IT hardware companies reported doing so.

Our findings on the timing at which these searches occur in startup companies is also interesting given that, here too, companies may face conflicting incentives. Because these searches are costly (both in terms of money and technology-employees' time), and given that these small startups are resource constrained (both in terms of time and money), it would stand to reason that at the margin companies would tend to delay these searches, if not put them off altogether. Conversely, to the extent that effective patent search is an information input into the innovation and technology-strategy planning processes, early

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search might yield greater benefits, especially to *technology* startups for which technical information is critical for both ongoing innovation and effective competition.

We find that those startups that do patent searches tend to conduct them relatively early in the commercialization process. Among the D&B population of companies, 65% report usually doing searches prior to product / process design, and 70% report that these searches are usually done during design and development.<sup>186</sup> We may have uncovered an element of “patent strategy” associated with this searching among our respondents, too: 14% report usually conducting examinations only when the company is planning to apply for its own patent (an event that may occur early or late in the commercialization process).

It is noteworthy that one third of the companies that conduct searches report usually doing so only after commercial launch. This result raises the possibility, consistent with our finding on patent licensing, that it is not uncommon for threats or other competitive information to arrive only after product launch. Since the company’s technology is likely to be most notorious after product launch, it is conceivable that the company’s competitors, or those interested in collecting royalties from the company, would be most active at that point. It is also possible that some companies “put off” costly searching until they are more certain of the economic value of a technology—a certainty that may only come to light after product launch.

A similar pattern obtains for the respondents in our venture-backed sample. For these companies, nearly six in ten relate usually doing searches prior to product / process design, with three quarters reporting that these searches are usually done during design and development. Like the D&B companies, one third note that the company usually

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<sup>186</sup> These percentages can sum to more than 100% because respondents were allowed to mark more than one category when identifying at which stage the company “usually” conducted the patent search.

searches the patent literature only after commercial launch, while nearly one quarter declare usually conducting examinations only when it is planning to apply for its own patent. But, because as we showed in Part III that venture-backed firms are more likely to hold patents, it may be that this increased share influences the higher likelihood among venture-backed firms to do searching at all when compared with the D&B respondents, fewer of whom hold patents. That there may be a “patent feedback mechanism”—with startups engaged in patenting being more likely to also examine the patent literature—is an interesting possible finding of our study deserving further research.

#### VIII. IS THE PATENT SYSTEM WORKING FOR U.S. TECHNOLOGY STARTUPS?

Our evidence suggests that, by and large, the patent system is neither working well, nor is it working poorly, for startup companies. We asked our respondents one pure “attitudinal” question, without a specific definition: “Overall, how well is the U.S. patent system working” ... “for your company,” and “for your industry?” We offered the respondents five options, including “very well,” “well,” “neither well nor poorly,” “poorly,” and “very poorly.” We had few expectations about what answers this question would yield, although we hypothesized, given the ongoing debate over the utility and validity of many software patents, that we would see answers from software companies skewed toward the “poorly” end of the scale. Moreover, we were particularly interested to see whether the responses from startups would exhibit an essentially “U”-shaped distribution, with answers populating disproportionately the polar ends of the scale, with many answering “very well” and others answering “very poorly,” with few in the center. Such a bi-modal distribution of answers would raise the possibility that our respondents

were self-selecting into our survey based on how passionate they felt about the patent system—whether they had a “love” or a “hate” attitude toward it.

In fact, we find that the responses to both questions were essentially normally distributed, with a mean and mode around the central answer. This result gives us confidence that our respondents were not primarily self-selecting based on their extreme passions, but also suggests that, by and large, executives in early-stage technology startups in the United States consider that the patent system, whether they are considering their company or their industry, is working neither well nor poorly. In essence, they appear in general to believe that the patent system is “muddling through.”

There are some inter-industry differences in these responses, but the deviations are not as great as we surmised they would be when we began the project. For instance, over 35% of respondents from the biotechnology industry answered that the patent system was working “well” for their company, but the most common answer (the mode of the distribution) was still the central answer, “neither well nor poorly.” Among software companies, the most common answer (the modal answer) as regards their company was again the central answer, with over 55% of the respondents selecting this middle choice.<sup>187</sup>

Surprising to us was the opinion among these startups that the patent system was, in general, working less well for their industries than for their companies. Among the biotechnology companies, for example, the pattern for “how well is the patent system working for your industry” was the mirror image of the answers to the “company”

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<sup>187</sup> It is worth speculating whether these respondents were prone to the “central answer” bias reported elsewhere in the literature on surveys, although this same phenomenon did not seem to dominate their answers on other questions. See generally Eric A. Greenleaf, *Improving rating scale measures by detecting and correcting bias components in some response styles*. J. OF MARKETING RES., 29(May), 176-188.

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question—the mode was the same (the central answer), but over 35% of the respondents said they believed the patent system was working “poorly” for their industry. Given that patenting in the “discrete” technology of biotechnology is usually held out as an example of how well the U.S. patent system is operating, this shared opinion among these biotechnology executives raises more questions than it answers. Software and internet executives’ answers were virtually identical on the “industry” question to those of the biotechnology responses, with the most common answer in the center of the choices, but over 35% of respondents indicating that the patent system was working “poorly” for their industry.

So, executives from both the D&B sample (essentially drawn from the population of early-stage technology companies in the U.S.) and the *VentureXpert* sample of high-quality, venture-backed firms are saying, at best, that the patent system is neither working poorly nor well, and at worst that they sense it is working poorly for their companies and their competitors. Such a finding does not bode well for our system. In the opinion of this “entrepreneurial class,” a system that is a chief legal support for innovation in the United States does not appear to be working particularly well.

### IX. CONCLUSION

By conducting a reasonably comprehensive survey on the relationship of the U.S. patent system to technology entrepreneurship, we have attempted to fill an important gap in the considerable body of work exploring intellectual property and, more generally, innovation. Importantly, our detailed results do not offer simple answers concerning the relationship of intellectual property rights and entrepreneurial activity. For instance, we

discover that technology startups are generally more likely to hold patents—and more likely to hold greater numbers of patents—than was previously believed. But we also reveal that these same companies report that patents are providing relatively weak incentives for core innovative activities, such as invention, development, and commercialization. The analysis herein has been aimed at uncovering the motives for technology entrepreneurs acquiring and filing patents when those patents—according to the judgment of those same entrepreneurs—are not offering particularly strong incentives to engage in what are generally considered core innovative activities.

Our response to the questions raised by these discordant streams has been both nuanced and multifaceted. We report that a large share of startups, especially in the software industry, “opt out” of patenting altogether. Although startups appear to be more aggressively accessing the patent system than previously reported, we find that these effects reflect our survey’s ability to measure difficult-to-capture patent holdings—specifically, the number of patents originating from founders and acquisitions, and patent applications filed—as opposed to, necessarily, an upward shift in startup filing rates.

We also report that, for many patent-holding startup companies, patents are an important part of the mix of strategies used by the firm to capture competitive advantage from its technology. But this important role tends to be much more pronounced among biotechnology and “hardware” companies (including both medical “hardware” such as surgical devices, and IT hardware, such as computers and semiconductors) than among software and Internet startups. In fact, we find that for software and Internet companies, patents generally serve a much less important function in almost all of the entrepreneurial activities about which we surveyed.

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These disparate findings trumpet a major result of our study: the industry in which a startup operates tends to exert a strong influence on the role that patents play in the firm's entrepreneurial activities. This finding may be driven by underlying technology differences in these sectors, variation in industrial organization, or other unseen factors. The deep difference we find in the use and utility of patents by startups across industries tracks many of the patent reform debates of recent years, and while some of the understanding that flows from those debates is useful in explaining our results, we find that startups can be quite different from their larger counterparts in their patenting behavior. As such, more research into the drivers of these industry differences at the level of the startup is needed.

This article also demonstrates profound differences in the manner and extent to which patents are used by companies that have succeeded in securing venture-capital funding, as compared to those that have not. In a related series of findings, we report that patents are useful to startups in attracting entrepreneurial capital and, relatedly, for improving the likelihood of a successful "liquidity event" (such as being acquired or going public). In an important new showing, we demonstrate that patenting may be playing a heretofore underappreciated and important role in helping startups to secure investment from various sources, including "friends and family" and commercial banks, as well as angel investors and venture capital—although these results, too, are context specific. These findings may partly explain why in general venture-backed startups are more apt to use patents, and consider them important—since evidence we report suggests that these companies have been "selected" upon by VC investors for their patents. But

here too more study is needed to uncover the dynamics of the patent-financing relationship in technology entrepreneurship.

Our survey also uncovers nuanced explanations for why technology entrepreneurs use the patent system. Contrary to some previous anecdotal accounts, those firms that file for patents do so primarily to prevent others from copying their products and services. Additionally, our study is the first to suggest that startups may be using patents in strategic ways, such as to improve bargaining positions in cross-licensing deals and defend against infringement suits, previously believed only to be significant motivations for larger-firm patenting.

Last, we report that our respondents believe, by and large, that the patent system is not working particularly well for their companies or their industries, even in the fields of biotechnology, medical devices, and computer hardware, where our survey suggests patents are considered to be more useful for a range of reasons. Because many studies have shown that entrepreneurs and their firms play a substantial role in driving innovation, employment and economic growth, we strongly believe that further study is warranted to determine how the system might be reformed to better serve the needs of startups.

In the meantime, following on this article, we plan to further explore our survey data in a series of articles examining specific sets of results in our survey. These include the drivers of patenting by entrepreneurs,<sup>188</sup> the role patents are playing among software and Internet startups,<sup>189</sup> the role of patents in entrepreneurial “markets for technology,”

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<sup>188</sup> See Sichelman & Graham, *supra* note \_\_.

<sup>189</sup> See Samuelson & Graham, *supra* note \_\_.



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the effects of patents in allowing startups to enter new markets,<sup>190</sup> the role of patents on market valuation and exit, and a host of other topics.

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<sup>190</sup> See Sichelman, *supra* note \_\_.