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## Appendix B: Views from the Trenches

### *VCs, Startups, and Small Business Stories*

#### **DAN RAVICHER, EXECUTIVE DIRECTOR OF PUBLIC PATENT FOUNDATION (PUBPAT)**

*Dan Ravicher is Executive Director of the Public Patent Foundation (PUBPAT), a non-profit founded in 2003 whose mission is to protect freedom in the patent system. PUBPAT advocates for improvements to the patent system and educates the public about how the patent system impacts everyday life. It also undertakes specific litigation and reexamination matters to defend individuals, non-profits, and small businesses from invalid patents. Many of its matters have been against patents held by “trolls,” and it has resolved matters for parties in litigation against Lodsys and Arrivalstar.*

##### ***What’s it like for a small startup to receive a patent demand?***

The logo for the Public Patent Foundation is a blue rectangle with white text. The top line reads "Public Patent Foundation" in a large, bold, sans-serif font. The bottom line reads "Representing the Public's Interests in the Patent System" in a smaller, regular, sans-serif font.

Imagine you’re a small startup business. You have three employees, including yourself, and you make about \$500K per year in revenue. You get a patent infringement letter and are referred to some patent attorney who tells you they charge \$500 an hour and will take at least 40 to 60 hours to review the matter. Then, if you want this attorney to respond to the patent holder, that’s another 20 hours to write letters, do conference calls, etc. Before you know it, you’ve spent \$50K and had to lay off one of your employees. All this time the patent holder is offering to settle for \$20 to 40K. What are you going to do?

##### ***Which of the different ideas out there would make a difference to your clients?***

Our clients don’t have the financial ability to hire any patent attorneys to represent them, so proposals that merely create more legal mechanisms for challenging patents or deterring them through litigation won’t be of any help. Rather, my clients need a system that provides pro bono legal counsel or shelter from such risks, either through an exemption or immunity under patent law, or informally through some private risk sharing arrangement like insurance. Individuals, non-profits, and small businesses don’t have the money, or the time, to get involved in protracted patent litigation, so proposals like fee-shifting won’t help, because they will never get there.

##### ***What private sector solution do you favor?***

In most other areas of the law we have a solution called insurance. A small business buys liability insurance to protect against customers who get injured in their store or using their products. They get insurance for workman’s comp, discrimination claims, etc. If and when they get sued, the insurance company has the deep pockets to defend them. And since the patent holder may be targeting many of the insurance company’s clients, they have an incentive to play hardball. That alone will cause the nickel and dime trolls (as I call them) who focus on small companies to go away. There are many benefits risk consolidation can provide, including overall risk reduction through policy and doctrinal changes that only an insurance company can have sufficient resources and incentives to effectively pursue. But, the mere aggregation of risk produces an efficiency gain as well while effectively allowing disparate small businesses to

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work together to fight common enemies.

For example, in the automobile context, you have thousands of potential plaintiffs suing thousands of potential defendants. So, the insurance companies can use actuarial data to assess value of claims and realize the benefits of spending more to fight a case than it is worth because the overall deterrent effect to other minor claims resulting from that reputation they establish for themselves. Similarly, if there was an insurer offering patent infringement defense insurance either as an add-on or part of general business liability insurance, then those insurers will have the resources and incentives to fight any minor claim made against any of their insured so as to establish a habit of not paying out minor claims.

Insurance is critical for businesses to survive the gamut of tort and employee suits they're constantly subject to. So long as there are plenty of small claims being made to make the transaction cost of insurance worthwhile, it can solve the patent nuisance claim problem, too. Also, with IP claims, insurers could offer only policies to cover the cost of defense, not any underlying liability or loss of business resulting from an injunction. They could also cap their payments to \$1M in expenses. That's enough to mount a defense to a nuisance suit troll and make them go away.

### ***What public sector solution(s) do you favor?***

Much like states are immune from patent infringement under the 11th Amendment, Congress could establish an exemption for micro businesses (revenues under, say, \$1 to 10M per year) from patent infringement. Any business that small can't afford to hire patent attorneys to defend themselves, and it isn't really worth it to the patent holder to litigate either, as the potential damages is less than \$10 to 100K. For trolls suing or threatening such businesses, their purpose is solely to extract a nuisance payment, and while that violates Rule 11, no small business will be able to afford to hire an attorney to pursue a Rule 11 claim on their behalf. It would cost at least \$100K and take at least two years to pursue a Rule 11 finding, which no small business is ever going to be able to take advantage of.

So, why not just categorically exempt micro businesses from patent infringement? To implement that, the law could require any notice letters or complaints alleging patent infringement to specifically inform the recipient/defendant that the exemption exists along with a form declaration that can be returned by the recipient swearing they qualify for the exemption. Any letter that doesn't include the notice and form of declaration does not qualify for purposes of putting the recipient on notice and any complaint served without the notice and form of declaration is to be dismissed by the Court on its own initiative without motion or appearance by the defendant. A party filing a lawsuit, when they file the affidavit of service, must also file an affidavit that the notice of exemption and form declaration was served on the defendant as well.

Also, one of the most critical problems is the issuance of so many invalid patents by the Patent Office. The PTO makes ten times as much money from granting patents as it does from denying patents, and examiners have a much easier time making their quota by granting patents, because no one objects, than from rejecting a patent and defending that rejection repeatedly. Until the incentives placed on the office and its employees to grant, rather than deny, patents are addressed, there will be too many invalid patents issued that can be strategically used by their holders to extract undeserved settlements from others.

### ***What advice would you give to lawmakers about reforming patent law?***

As you think about proposals, really ask yourself how what you're considering would help the small businesses who

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can't afford legal work. Focus on that person, who's being targeted by the nickel and dime trolls (as I call them), which are a completely different beast from the home run trolls (as I call them) who want to sue deep pockets on purpose to get a big judgment. I'm not worried about the deep pocket trolls so much because the deep pockets they sue will be able to hire lawyers and defend themselves.

Eliminate injunctions entirely, as the patent system is an economic tool, not a civil liberty. There is always some amount of money that can adequately compensate a patentee for infringement (i.e. a trillion dollars would never be declined by a rational patentee). Thus, courts should not be focused on whether to grant an injunction, but instead what amount of ongoing royalty to require the infringer to pay.

Change the incentives at the PTO to grant patents. The decision to grant or deny a patent should be entirely uninfluenced by any macro or micro level economic concern. The fee structure and quota system both need substantial revision.

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## LAURA SMITH, INTELLECTUAL PROPERTY MANAGER

*Names and details have been changed to protect the identity of the author.*

I was Intellectual Property Manager of a Boston-based venture backed company with around 500 employees and \$40M/year revenue at its peak competing in a fast-paced environment. We were sued by an individual inventor, father-son team. They had filed a large number of patents and weren't doing anything with the technology.

We knew within about 24 hours of the original suit being filed that we did not infringe, because the inventor included a strongly worded disclaimer in his specification. So we did not settle upfront. From our perspective it was an open and shut case.

But it took a year to get to a claim construction where we could make the case. In this first year we spent about 100K a month. That was bad enough. But then the judge sat on it. During this time we went through discovery at a run-rate of \$200k per month. We were a startup not making a profit. But if we were, that amount would have been a significant portion of it.

A year and a half later, the judge FINALLY issued our claim construction ruling. He was not able to provide any reasoning or analysis in his opinion and stated that, "with trial in this matter rapidly approaching, the court does not wish to add further delay to the constructions by its preparation of a complete opinion setting forth its reasoning and analysis." So, he realized he was taking way too long and decided to simply issue his ruling without a full opinion.

To make matters worse, his ruling made it infinitely clear that we CANNOT POSSIBLY INFRINGE. We knew this from the start. So not only did we spend \$3 million in fees waiting around for a claim construction, but when it finally arrived it was clear the plaintiff had no case and the whole exercise was a waste. The plaintiff immediately stipulated to non-infringement.

Meanwhile, the guys filed suit over another two patents. They filed for these patents after the benefit of the Markman hearing during which the inventor sat there and got an eight hour tutorial on how to write a better patent on our

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technology. He then went home and did it. Of course, he claimed priority to much earlier applications with 70 to 80 page disclosures.

When faced with the second suit, we knew we would spend all this money again to go into this entire process, and we would pay all that money and be worse off. So even though we had won the first time, the second time it was much more attractive to settle—in the low seven figures—than to fight.

We had run out of cash and were in talks with a Chinese company that didn't want to deal with it. All of the arguments—there's just no way in hell a jury will pay attention it. We had agreed on the price of the company. But then the buyer used the lawsuit as leverage to get the price down on the order of \$10 million due to the outstanding lawsuit—20% of the value of the company. They said this is a \$20M liability which was bogus. But we didn't have the money to settle it.

### ***What can be done?***

#### *Issue claim construction on the day of the ruling*

Right after this case, the judge changed his practice. Now he issues claim construction on the day of the ruling. That would have saved us a lot of pain.

This should be a requirement, that you get it done right then. You'll never have a better understanding of the case than on that day. The longer you wait, the more unfamiliar the material becomes. Even if we had lost, we would have written the check and settled, rather than spending another \$1.5M on discovery.

#### *Advice to small companies: Chose a more affordable counsel early on*

We made a huge mistake in choosing our counsel. We picked based on the personality of the lead trial lawyer. From day one, we were choosing based on the person that we wanted representing us at trial and the prestige of the law firm—and go to the board and say, “look we have a fancy lawyer.” We should have done the reverse—chosen an unfancy lawyer from a much smaller firm, and with a fixed fee. If we got to the point where it looked like trial was likely, we could switch the lawyer 3 to 6 months ahead of time. We're a good example of how not to buy legal services.

Given all the issues you have to deal with at the beginning, it would be my recommendation to go much cheaper, or even have one that is willing to go for a fixed fee. You don't need the most prestigious firm to handle discovery.

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## **DON ELLSON, PRIVATE EQUITY INVESTOR**

*Don Ellson (not his real name) is a Principal at a private equity firm with over a decade of experience investing in early-stage high-tech companies.*

Two of our companies have sold patents to NPEs. The first company has been around a long time, so its patents are old. It has now been on the receiving end of three lawsuits by NPEs; in all three we were forced to settle. The suits were devastating to the company—they almost killed the company.

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One suit hit the company at a very vulnerable time and almost put it out of business. The company learned a lot from these experiences and turned around and started licensing to NPEs. The first time they did it, they needed the money. But then—this is going to sound like prostitution—they realized this was an opportunity to bring more resources into the company... Since the first sale, they have periodically looked at their portfolio, and sold groups of patents to different litigation entities. Another lawsuit the company had was actually from a NPE that acquired a patent from another one of our portfolio companies. I learned this while in the due diligence process while investing in the company that sold. The person who sold that patent recently told me he regrets selling it, and the company has made a point of not pursuing any additional patent licensing.

Net-net, I wish we had never been on either offense or defense. I think the company would have been better off had it never been sued for infringement and never sold patents. In fact, the benefit of selling patents—their own use of the system—didn't offset the pain of the lawsuits.

I think patent trolls have a very negative impact for a couple of reasons. First, companies have been forced to spend a lot of money that would have otherwise gone into innovation, either because they are defending patents, or filing and managing patents—an expensive process in its own right. It's also creating friction in the acquisition process. Buyers are warier because they are worried about buying a company and getting sued. On a lot of fronts, it's been a negative on innovation and I don't see it anywhere as driving innovation. In certain areas—in pharma—patents work. In the software world, it's very much been a negative. I'd rather there be no patents than the current system. Everyone I know shares the view that trolls are having a negative impact on innovation.

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## KATE ENDRESS, FOUNDER AND CEO OF DITTO.COM

*Kate Endress is an athlete turned investor turned e-commerce entrepreneur. After graduating from Stanford Business School in 2011, Kate cofounded DITTO.com, an ecommerce site selling designer sunglasses and eyewear which features cutting edge new video “try-on” technology.*



### ***Who are you and why did you partner with a patent troll?***

I am the CEO and Cofounder of DITTO.com, a company I started to make ecommerce work for verticals that had currently not migrated online – those with fitted merchandise. After raising a seed round, my founders and I worked countless hours to build our team, file for patents on our technology, and build a scalable website. We launched our site in April 2012 featuring fitted eyewear and were off to the races.

We were planning to raise a Series A round during the summer of 2013 but before we could, we were sued for patent infringement by our biggest competitor, Wellpoint, who owns 1-800-Contacts and Glasses.com. Just like that, we were faced with an “injunction” threat from a \$25B competitor. I was terrified our years of hard work were for naught.

As it turns out, after seeing our technology, Wellpoint launched its own offering and immediately bought a patent which they are now using to sue us. It took me some time to come to grips with that fact that a \$25B healthcare

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company who carefully crafts the image of being compassionate and caring towards the consumer would go on the aggressive against a 13-person startup. I can only speculate that they fear that the patents we filed (which take years to issue!) will become a weapon towards them down the road. But if they would have just called me before filing a lawsuit against us, they would know we applied for those patents for defensive purposes, not offensive ones. I care more about building a superior customer experience than I do about going after them with patents.

I had to come up with a defense strategy. After doing our own assessment and talking with a host of talented lawyers, we still don't think we infringe. But how expensive it would be! Every attorney I spoke with estimated it would take several million dollars over several years to prove that we didn't infringe. Obviously we weren't a position to be able to afford that! I stopped all marketing spending to ensure every dollar went to support our litigation, I laid off several employees to further stem costs, and then I went searching for someone who could help.

I worked my tail off to find a lawyer to work for equity on my case, to no avail. Several were willing to take half equity or quarter equity in my company but it wasn't enough given their outrageous hourly fees. I had one lawyer friend who was going to quit his job at his big firm to work for me, but I realized one young litigator from Indiana wasn't going to be enough to battle this \$20B company in Utah. When you get sued in Utah, you must have a Utah-based litigator to defend you, which was difficult given that we are located in the Bay Area. I also worked hard to find an investor to fund our fight, but the feedback was consistent: "You have a \$25B competitor who put a target on your back. Why wouldn't they just keep purchasing patents to keep suing you to run you out of business? It's too risky." The fact that legal fees are often sunk costs (given that there isn't a fee-shifting mechanism in place yet) also makes it harder to raise money for litigation.

I even went so far as to run a sale process for my business, which was incredibly depressing. Buyers were dingding our valuation \$3 to 4M for the lawsuit, so I felt we couldn't even sell it for what it was worth.

It was a challenging five months as I figured out a game plan that gave us a path forward and a shot. That solution was a deal with Erich Spangenberg. Many people think of Erich as a patent troll. I met him while speaking as a panelist at a patent reform conference a few months ago and my first reaction to him was probably exactly what you think. I had a clenched jaw and a red neck (I'm the worst poker player ever because I literally wear my emotions). But we got to speaking and he told me that as he heard me speak, he realized that there was an incredible opportunity. He went on to explain his plan to take on my case, pay for all legal expenses associated with it, and free me up to run my business in exchange for equity in my business on a contingency basis for about half of what I was projecting it would cost me in cash to fight it myself. I was skeptical at first, but the more diligence I did on him and this deal, the more I realized it was a very smart (if not opportunistic) market-based solution to my problem. His offer made sense because 1) it makes us less vulnerable due to his reputation and resources, so it reduces the chance of being sued over and over; 2) the price we negotiated was fair given the circumstances; 3) he has real domain expertise and an arbitrage opportunity on costs; 4) he has a much higher likelihood to negotiate our lawsuit away given his resources and assets; 5) I could go back to running my business and not be neck-deep in litigation for a few years, which would have created huge negative consequences for my company and team.

Erich Spangenberg sees this as an opportunity to get equity in great startups for doing what he does best. So until the day that we have a properly functioning patent system, his solution is my best option. When a huge company puts a target on your back, sometimes you need to powerful friends to have a shot at surviving.



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## BRAD BURNHAM, UNION SQUARE VENTURES

*Brad Burnham is a managing partner at Union Square Ventures (USV), an early stage venture capital firm based in New York City focused on young companies that use information technology in innovative ways to create high growth business opportunities. Over the past 10 years, it has been directly involved in the development of 61 companies and has, through its prior firms, participated in the launch of over 120 companies.*



### Union Square Ventures

Union Square Ventures, founded in 2003, is a venture capital firm based in New York City.

The firm currently manages \$450,000,000 across three funds. Companies in Union Square Ventures investment portfolio include Twitter, Tumblr, Etsy, Foursquare and Kickstarter, among others.

*NOTE: The following is adopted from testimony provided to the FTC/DOJ at their workshop on Patent Assertion Entities on December 10, 2012.*

I'm an investor who invests primarily in internet services. With that I come to this question with a unique perspective. We were, for instance, the first institutional investor in Twitter, Tumblr, Foursquare, Etsy, four companies that have now created over 1,500 jobs. I have become very involved in the patent question, because about one-third of our portfolio—we have 45 companies in the portfolio—has been sued by someone. About almost half has been given some kind of demand letter by someone.

Twitter for instance has 14 active patent actions against it—once you get to a certain scale, everybody comes out of the woodwork and asserts that you have violated their intellectual property. What's frustrating about this from my perspective as an investor is that none of these companies that we have invested in knew about these patents. And I've heard arguments made that, well, gosh, they were irresponsible. They could have searched the patent office to find these patents. But in fact, that really is not true. Most of the patents that have been asserted were asserted from an entirely different field.

I'll use one example of a company that is not entirely out of business, but is a tiny shell of its former self as a result of being subjected to two patent suits in rapid succession by two different entities, neither of which would fit the definition of an NPE or a PAE. Both were failed entrants. Both were failed start-ups. The company was in the business of providing advertising services to major brands. The first suit that we were hit with was from a company that was not in the business of advertising services at all. It was a business-to-business company that was providing software, not services, to a completely different industry—law enforcement. There's no way we could have searched for that patent.

The second suit we were hit with also was so completely different than what we were doing. That hurt when they sued us. But it didn't have a huge effect. They hadn't gotten an injunction.

But then they went on to sue our customers. So these are people like American Express and American Airlines, and General Motors. The company in question employed 70 people. We were doing about \$10 million in annual revenue,

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and when they sued our customers, this was a nice to have, not a need to have, it was a marketing program for the customers. The suits cut our revenue in half in three months. And so we couldn't sustain the 70 people that we had on the payroll, and so we had to cut the company in half.

And as we fought this patent suit, we tried to indemnify our customers. Our customers said "Thanks, but I mean, it's not going to help. It's not worth it for me. I don't want to be involved in this. You figure it out."

And so ultimately we were not able to raise additional capital into the company, and we ultimately shrunk the company back to five. The company now has five people servicing their existing clients, and no longer employing those 70, or 65 people that they had employed.