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**GIVE THE START-UPS A CHANCE: INNOVATION, THE
AMERICAN ECONOMY AND THE ARGUMENT FOR
CARVING IP ABS AND SPECIFICALLY PATENT ABS OUT
FROM 17 C.F.R. § 229.1111 AND 17 C.F.R. § 230.193**

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ABSTRACT

This article considers the effects 17 C.F.R. § 229.1111 (“§ 229.111”) and 17 C.F.R. § 230.193 (“§ 230.193”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) will have on the use of intellectual property in asset-backed securities. First, it discusses the history and mechanics of intellectual property (“IP”) being used in asset-backed securities (“ABS”). Next, it considers the importance these financial instruments can play for companies in which value creation is heavily intertwined with intellectual property. Then, the article analyzes how the Dodd-Frank Act and § 229.1111 and § 230.193 will impact the issuance of IP ABS, specifically patent ABS, and how this impact will influence the American economy. The article concludes with a discussion of why IP ABS, and specifically patent ABS, should be excluded from the requirements of § 229.1111 and § 230.193.

I. INTRODUCTION

Imagine, for a moment, the company Apple does not exist. Imagine the company, and vision Steve Jobs developed, was unable to find the foundation and support to allow Apple and its patents to develop into the company it has become today. Accordingly, the patents that led to products such as the iPod, iPad, iTunes, and the Mac would not have come to fruition. The absence of Apple and the patents it developed would have a drastic effect on the myriad of individuals who own an Apple product, as evidenced by the

company's \$360 billion market capitalization.¹ However, the inexistence of a company like Apple, and more importantly the patents it created, would have even more far-reaching effects on the American economy. A corporation with patents, such as Apple, provides vital innovations to the American economy. Innovation is considered to be a primary driver of long-term growth and economic prosperity for the United States economy.² Yet, new rules implemented by the Securities and Exchange Commission threaten to place a significant impediment in the path of many business entities that could provide considerable innovation and development for the American economy.

In this article, I will consider the effects 17 C.F.R. § 229.1111 (“§ 229.111”) and 17 C.F.R. § 230.193 (“§ 230.193”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) will have on the use of intellectual property in asset-backed securities. First, I will discuss the history and mechanics of intellectual property (“IP”) being used in asset-backed securities (“ABS”). Next, I will consider the importance these financial instruments can play for companies in which value creation is heavily intertwined with intellectual property. Then, I will analyze how the Dodd-Frank Act and § 229.1111 and § 230.193 will impact the issuance of IP ABS, specifically patent ABS, and how this impact will influence the American economy. I will conclude the comment with a discussion of why IP ABS, and specifically patent ABS, should be excluded from the requirements of § 229.1111 and § 230.193.

II. ASSET-BACKED SECURITIES AND THE DEVELOPMENT OF THE ASSET-BACKED SECURITIES MARKET

Securitization is a process that uses assets with normally predictable cash flows and common features and packages them into interest-bearing securities with marketable investment characteristics.³ Securitization is “a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfer the same to investors either with or without the support of

¹ Brian Caulfield, *Emerging Middle Classes to Boost Apple Sales By \$68 Billion*, FORBES (Sept. 20, 2011), <http://www.forbes.com/sites/briancaulfield/2011/09/20/emerging-middle-classes-to-boost-apple-sales-by-68-billion-by-2015>.

² *The Recovery Act, Transforming the American Economy Through Innovation: Introduction*, THE WHITE HOUSE, <http://www.whitehouse.gov/recovery/innovations/introduction-innovation> (last visited Oct. 2, 2011).

³ THE FED. DEPOSIT INS. CORP., *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980-1994* 405 (1998), available at <http://www.fdic.gov/bank/historical/managing/history1-cr.pdf>.

further collaterals, and thereby achieve the purpose of financing.”⁴ Essentially, the entity securitizing its assets is selling a stream of cash flows that in the future will accrue for the entity.⁵ Thus, a key difference between asset-based lending and traditional lending is where the lender focuses his attention. With traditional lending, the lender chiefly focuses on the borrower’s cash flow, but with asset-based lending, the lender chiefly focuses on the borrower’s collateral.⁶ Initially, mortgages were used as the underlying asset for a securitization transaction.⁷ Due to the consistent nature of payments found with a mortgage, it was an asset that worked nicely with a securitization transaction.⁸

As a financial instrument, a patent ABS is fundamentally similar to a mortgage-backed security.⁹ With a patent ABS, the security is backed by the asset of royalty payments, rather than mortgage payments.¹⁰ The ability of IP to be licensed is fundamental to its use in securitization.¹¹ In a license agreement, the owner of a patent exchanges his right to exclude others from using the patented technology in exchange for regular license payments.¹² The success of a securitization depends on regular cash flow.¹³ Thus, in looking at a patent license agreement from a securitization point of view, the patent

⁴ DAVID EDWARDS, PATENT BACKED SECURITIZATION: BLUEPRINT FOR A NEW ASSET CLASS 1 (citing VINOD KOTHARI, SECURITISATION: THE FINANCIAL INSTRUMENT OF THE NEW MILLENNIUM (1999)), http://www.securitization.net/pdf/gerling_new_0302.pdf (last visited Feb. 8, 2012).

⁵ *Id.*

⁶ Xuan-Thao Nguyen, *Collateralizing Intellectual Property*, 42 GA. L. REV. 1, 14 (2007) (citing *FAQS: Bank of America Business Capital*, BANK OF AMERICA, http://corp.bankofamerica.com/public/public.portal?_pd_page_label=products/abf/products/faqs#2 (last visited Oct. 19, 2007)).

⁷ Aleksandar Nikolic, *Securitization of Patents and its Continued Viability in Light of the Current Economic Conditions*, 19 ALB. L.J. SCI. & TECH. 393, 398 (2009).

⁸ *Id.*

⁹ *Asset-Backed Security - ABS*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/asset-backedsecurity.asp#axzz1lqESncTr> (last visited Feb. 11, 2012) (defining an ABS as “essentially the same thing as a mortgage-backed security, except that the securities backing it are assets such as loans, leases, credit card debt, a company’s receivables, royalties and so on, and not mortgage-based securities.”).

¹⁰ *See id.*

¹¹ *See* Nikolic, *supra* note 7, at 397.

¹² *See id.* at 397-98 (citing Amy L. Landers, *Let the Games Begin: Incentives to Innovation in the New Economy of Intellectual Property Law*, 46 SANTA CLARA L. REV. 307, 307-08, 308 n.3 (2006)) (“Through licensing the inventor would allow another to profit from his efforts in exchange for regular license payments.”).

¹³ *See* Nikolic, *supra* note 7, at 404.

can be conceptualized “as a potential right to a future series of cash flows” from exclusive use of the patented technology.¹⁴

The mechanics of an IP ABS work in the following manner. In using a patent, the debtor-business entity that developed the patented technology (“the originator”) sells that technology to a special purpose entity (“SPE”).¹⁵ The SPE is a wholly owned subsidiary of the originator.¹⁶ Next, the SPE appropriates a license back to the originator and to any other entity it would want to be a licensee.¹⁷ In order for the SPE to pay the originator for the sale of the patented technology, the SPE issues debt securities in the market.¹⁸ The debt securities issued by the SPE are backed with the future revenue streams from the originator and other licensees.¹⁹ In essence, the originator is selling future cash flows in exchange for the current proceeds of the debt securities.²⁰

In 1997, the number of known IP ABS transactions totaled \$380 million.²¹ By the year 2000, this number had grown to \$1.13 billion.²² In 2003, Royalty Pharma structured a securitization issuing \$225 million in AAA rated bonds backed by biopharmaceutical patents.²³ More recently, there has been significant activity with IP ABS using trademarks and franchising fees. From 2005 to 2007, companies such as Dunkin’ Brands, Quiznos, Sear’s Holding Corporation, IHOP, and Domino’s Pizza established IP-based ABS backed by trademark and franchise royalties ranging from \$200 million to \$1.85 billion.²⁴ However, patent-based ABS are not nearly as common as the use of trademarks or franchise royalties with ABS.²⁵ As Dr. Elliott Fishman,

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See Ariel Glasner, *Making Something Out of “Nothing” The Trend Towards Securitizing Intellectual Property and the Legal Obstacles That Remain*, 3 J. LEGAL TECH. RISK MGMT. 27, 29 (2008).

¹⁷ Nikolic, *supra* note 7, at 404 (citing Joseph A. Agiato, *The Basics of Financing Intellectual Property Royalties*, FROM IDEAS TO ASSETS: INVESTING WISELY IN INTELLECTUAL PROPERTY 111, 117 (Bruce Bermaned, John Wiley & Sons, Inc. 2002)); Glasner, *supra* note 16, at 32.

¹⁸ Glasner, *supra* note 16, at 31.

¹⁹ Nikolic, *supra* note 7, at 404 (citing Glasner, *supra* note 16, at 35).

²⁰ See *id.*; Glasner, *supra* note 16, at 31 (“The SPV manages the purchase of the assets by issuing debt securities or debt-like instruments in the bond market or to private institutional investors, and applying the cash raised to the payment to the originator.”).

²¹ EDWARDS, *supra* note 4, at 4.

²² *Id.*

²³ Glasner, *supra* note 16, at 38-39.

²⁴ See *id.* at 39-40.

²⁵ See *id.*

Managing Director of the consulting firm Astrina Capital LLC, noted, “[a] handful of completed transactions has shown how IP royalty streams can be valued, rated and then securitized like bonds. But the jury is still out whether these transactions will become more universally pursued.”²⁶

III. IMPORTANCE OF PATENT ABS TO START-UP BUSINESSES

Even though the jury may still be out on securitizing IP royalty streams, there seems to be continued interest from businesses and the financial community in using IP as a source of financing and collateral.²⁷ This trend will likely continue as IP assets grow in their recognition as essential business assets and IP owners want to pursue the opportunity of making them profit centers.²⁸ Combining this trend with the suggestion that intangibles are responsible for seventy percent of the current value of equities in the United States, it appears there will be a continued interest and desire to use patents in ABS.²⁹ In fact, one of the leading North American financial services providers, Harris Nesbitt, viewed IP ABS as one of the most attractive areas for growth.³⁰

A. The Inability for Start-Up Companies to Obtain Traditional Financing

The use and development of IP ABS can be vital to start-up firms that have a majority of their assets related to IP. The patent ABS can

²⁶ Elliot A. Fishman, *Securitization of IP Royalty Streams: Assessing the Landscape*, TECH. ACCESS REP., Sept. 2003, at 1, 6, available at http://www.astrinacapital.com/images/e_fishman_securing_IP.pdf.

²⁷ See Cao Wei, *Research on Securitization of Intellectual Property for Small and Medium-Sized Enterprise Innovation*, PROC. OF THE 7TH INT’L CONF. ON INNOVATION & MGMT., at 1398, available at http://www.pucsp.br/icim/ingles/downloads/papers_2010/part_6/15_Research_on_Securitization_of_Intellectual_Property_for_Small_and.pdf.

²⁸ Vani Sharma, *Securitization of Intellectual Property Assets*, JURISONLINE.IN (June 30, 2011), <http://jurisonline.in/2011/06/securitization-of-intellectual-property-assets> (“[IP] management, including funding business activities, is now said to be a ‘pillar of [the] corporate approach.’”).

²⁹ See ROBERT J. SHAPIRO & KEVIN A. HASSETT, THE ECONOMIC VALUE OF INTELLECTUAL PROPERTY 13, available at <http://www.sonecon.com/docs/studies/IntellectualPropertyReport-October2005.pdf> (stating the percentage of current value of equities).

³⁰ Susan Miceli et al., *Intellectual Property-Backed Securitization: A Closer Look*, U.S. SECURITIZATION GROUP ASSET-BACKED UPDATE, February 2004, at 2, 3, available at http://www.securitization.net/pdf/SecNewsletter_Feb04.pdf (further explaining “[w]hile growth at the onset will continue to be slow, the origination pace should pick up in the foreseeable future.”).

be an essential tool to aid a company in gaining access to capital and funding its growth. The patent ABS provide a very viable option for start-ups and small entities to maintain their courses of business. Consider how a traditional lending transaction is undertaken. In analyzing a traditional lending arrangement from the creditor's viewpoint, the main focus of the creditor will be the likelihood that the debtor will default.³¹ A key determinant of the likelihood a debtor will default is the debtor's cash flow.³² For this reason, the creditor will typically require the debtor to have significant assets and financial stability before the creditor will engage in a traditional lending transaction.³³ Many start-up companies have an issue with these requirements because they are attempting to establish significant assets and stabilize their cash flows.³⁴ Usually, a more mature company has a greater chance of success in soliciting a creditor for a traditional loan instrument.³⁵ Often the start-up company is not considered to be credit-worthy by the creditor.³⁶ As a result, many start-up companies do not even qualify for conventional bank financing.³⁷

Even if the creditor is willing to make a traditional lending arrangement, the cost to the business seeking the financing may be too great. Because the start-up company is still attempting to solidify its cash flow and build its assets, a traditional lending arrangement will be seen as more risky.³⁸ Moreover, for start-up companies, obtaining financing through conventional methods is often even more unlikely, typically because IP assets will have a more prominent role in the business.³⁹ Frequently, the long-term success of many start-up companies is dependent on its IP assets.⁴⁰ Due to these factors, it will be difficult for start-up companies to establish substantial assets to a

³¹ EUR. COMM'N DIRECTORATE-GEN. FOR ENTER. & INDUS., INTELLECTUAL PROPERTY AND ACCESS TO FINANCE FOR HIGH GROWTH SMES 5 (2006), available at http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=1166.

³² See Nguyen, *supra* note 6 (“[W]hereas in traditional lending the bank primarily looks to the borrower’s cash flow.”).

³³ See Nikolic, *supra* note 7, at 399-400.

³⁴ See generally William Pirraglia, *Installment Loans for Startup Businesses*, HOUSTON CHRONICLE, <http://smallbusiness.chron.com/installment-loans-startup-businesses-2388.html> (last visited Feb. 26, 2012) (stating “[s]tartup businesses face more challenges than growing organizations, because new companies have no record of success.”).

³⁵ See Nguyen, *supra* note 6, at 14.

³⁶ See *id.*

³⁷ See Nikolic, *supra* note 7, at 399-400.

³⁸ See *id.*; see also Nguyen, *supra* note 6, at 14-15.

³⁹ See Nguyen, *supra* note 6, at 11 (“In many start up companies . . . intellectual property assets are often the single most valuable assets.”).

⁴⁰ See *id.* at 12.

degree of the creditor's liking.⁴¹ The creditor will require a higher return in exchange for engaging in a higher risk transaction.⁴² Accordingly, if a start-up business that maintains a prevailing amount of its value and assets in IP can qualify for a traditional lending transaction, it still may be precluded from arranging this transaction due to cost. Consequently, many start-up entities, with most of their assets and value connected to IP, must look to other avenues for financing.

B. The Pitfalls of Equity Financing

Another avenue for the start-up firm with its assets predominantly associated with IP is to obtain financing through equity.⁴³ This avenue entails the firm selling ownership interests in the company through stock.⁴⁴ The benefit of the equity option is that it does not impose a burden on the firm's cash flow in the form of required debt payments.⁴⁵ However, equity financing also has significant disadvantages. Start-up businesses with a multitude of their assets and value wrapped in IP that are unable to obtain traditional debt financing will most likely have to seek equity financing through venture capital.⁴⁶ Yet, equity financing with a venture capital firm usually results in the venture capital firm gaining significant control rights, a large equity interest in the business, and a dominant position of influence on the business's board.⁴⁷ The amount of control that a start-up business would be required to relinquish in order to procure financing from a venture capitalist may make this avenue undesirable and even impracticable.

⁴¹ See EUR. COMM'N DIRECTORATE-GEN. FOR ENTER. & INDUS., *supra* note 31, at 5 (stating how intangibles play a minor role for banks in rating a customer's creditworthiness).

⁴² See *Financial Concepts: The Risk/Return Tradeoff*, INVESTOPEDIA, <http://www.investopedia.com/university/concepts/concepts1.asp> (last visited Oct. 7, 2011).

⁴³ See STEVEN L. SCHWARCZ ET AL., *SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS* 2, 3 (Matthew Bender & Co., Inc. 2004).

⁴⁴ See *id.*

⁴⁵ See Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms*, 86 CAL. L. REV. 1, 31 n.150 (1998).

⁴⁶ See Eran Kahana, *Dot-Coms Hold Out Hope*, 10 BUS. L. TODAY 19, July/Aug. 2001, available at http://apps.americanbar.org/buslaw/blt/bltaug01_kahana.html (discussing venture capitalists willingness to invest in companies that are developing); see also Nikolic, *supra* note 7, at 399 ("Venture capitalists are entities willing to invest in riskier business enterprises . . .").

⁴⁷ See Nguyen, *supra* note 6, at 14; see also Nikolic, *supra* note 7, at 399.

C. Patent ABS and the Broader IP ABS Occupying the Gap

IP ABS, and specifically patent ABS, fills the void between conventional financing and financing from venture capitalists. At a time when equity financing from venture capitalists is undesirable and impracticable, start-up firms that do not qualify for conventional lending, and with significant value and assets tied to IP, can look to IP ABS or patent ABS as a viable option. An IP ABS infuses the start-up firm with the necessary cash it needs in order to continue and expand its operations.⁴⁸ Also, it is a mechanism through which the start-up firm is able to diversify its assets.⁴⁹ However, the start-up firm is still able to maintain control over the IP.⁵⁰ This is due to the fact that once the bonds are paid, the underlying IP rights revert to the start-up firm.⁵¹ Therefore, the start-up firm is able to raise financing against the value of its IP assets.⁵² By not having to rely on the credit of the firm to gain financing, procuring IP-based financing becomes a much more fiscally reasonable option.⁵³ Securitization becomes a natural fit for the start-up company because it is able to get a much lower cost of funds and a much higher advance rate if it goes into the capital markets issuing ABS.⁵⁴ Moreover, the start-up entity is able to leverage its IP assets.⁵⁵ Using an IP ABS, and particularly a patent ABS, enables an IP asset to accrue greater incremental capital.⁵⁶

Additionally, the start-up business can acquire capital without having to give up equity.⁵⁷ Through the IP ABS, and more narrowly the patent ABS, the start-up company is able to gain the funds it needs to build the growth of the company while not having to tap into the venture capital market.⁵⁸ This allows the start-up business to maintain

⁴⁸ See Christopher Kalanje, Consultant, World Intellectual Prop. Org., Address at the WIPO-MOST Intermediate Training Course: Role of IP in Raising Finance (Nov. 13, 2003), available at http://www.wipo.int/edocs/mdocs/sme/en/wipo_ip_bis_ge_03/wipo_ip_bis_ge_03_21-related1.pdf.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² See EDWARDS, *supra* note 4.

⁵³ See Nguyen, *supra* note 6, at 14; see also *Financial Concepts: The Risk/Return Tradeoff*, *supra* note 42.

⁵⁴ Interview by David Wanetick with Ronald S. Borod, Chair of Structured Fin. & Member of Brown Rudnick Berlack Israels LLP, & Donald R. Davis, Managing Dir. & Gen. Counsel at CommercialStrategies, LLC (Jan. 2007), [http://www.brownrudnick.com/nr/pdf/articles/REPRINT_Structured_Finance_IP_Securitization_Borod_Davis_IncreMental_Advantage_207\(2\).pdf](http://www.brownrudnick.com/nr/pdf/articles/REPRINT_Structured_Finance_IP_Securitization_Borod_Davis_IncreMental_Advantage_207(2).pdf).

⁵⁵ EDWARDS, *supra* note 4.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

control, which may be essential to the long-term success of the start-up.⁵⁹

An essential component to the success of most start-up entities is the ability for the start-up to get its employees to feel like founders in terms of ownership, emotional attachment, and responsibility.⁶⁰ Having an equity structure to incentivize employees is especially important in a start-up company in a technology-dependent industry.⁶¹ This is a result of the fact that the first few hires of a start-up company in a technology-dependent industry are the engineers and programmers.⁶² The engineers and programmers will drive the success of the start-up, so it is important for them to feel vested in the start-up company. Additionally, the equity structure can be integral for the start-up entity to maintain talent.⁶³

Lastly, using an IP ABS, and expressly a patent ABS, can place the start-up company in a much better and stronger position if it later feels it can pursue venture capital financing. The funds garnered from the IP ABS, and more particularly the patent ABS, can be used to develop the technology and business of the start-up company.⁶⁴ This allows the start-up company to build more leverage to take into a future venture capital deal.⁶⁵ Moreover, the use of an IP ABS and a patent ABS “signals both technological sophistication and a legal protection of competitive advantage. It can give important signals about start-up firms that often have difficulties accessing financial markets.”⁶⁶

Overall, an IP or patent ABS can be an essential tool for the success of start-up businesses. It occupies a very important area

⁵⁹ See Gladys Edmunds, *Tightrope: Small but Steady Changes Key to Maintaining Success*, USA TODAY (May 23, 2007, 2:07 AM), http://www.usatoday.com/money/smallbusiness/columnist/edmunds/2007-05-22-small-steady-changes_N.htm (stating small changes throughout the course of the business can be better for maintaining success rather than waiting to implement big changes).

⁶⁰ Ben Yoskovitz, *Changing Equity Structures for Early Startup Employees*, INSTIGATOR BLOG (Sept. 11, 2009), <http://www.instigatorblog.com/equity-early-startup-employees/2009/09/11>.

⁶¹ *Id.*

⁶² *Id.*

⁶³ See *id.* (stating the closer employees feel to being founders than employees, the more likely the start-up is to be successful); see also *Employee Stock Options*, U.S. SEC. & EXCH. COMM’N (Mar. 29, 2010), <http://www.sec.gov/answers/empopt.htm> (“Many companies use employee stock option plans to compensate, retain, and attract employees.”).

⁶⁴ EDWARDS, *supra* note 4.

⁶⁵ See *id.*

⁶⁶ EUR. COMM’N DIRECTORATE-GEN. FOR ENTER. & INDUS., *supra* note 31.

between conventional financing and venture capital financing. It also provides another option of financing and gives the start-up company more flexibility in determining the best manner in which to pursue financing. This flexibility can be integral to sustaining a start-up business especially in light of the fact start-ups have a small chance of success.⁶⁷ It is estimated that first-time entrepreneurs only have a 20.8 percent chance of succeeding.⁶⁸ Second-time entrepreneurs only have a twenty to thirty percent chance of succeeding, depending on if the entrepreneur succeeded in his first venture.⁶⁹ Furthermore, an IP ABS, and specifically a patent ABS, can be an even more essential tool for success for start-up companies in high-technology industries. The rapid pace of technological progress does not allow for a start-up to have a slow growth curve.⁷⁰ Also, many technology companies use capital strategically as a competitive weapon to expedite progress.⁷¹ Therefore, having an IP ABS and patent ABS option for financing can be fundamental to a start-up company's ability to thrive and survive in a high-technology dependent industry.

IV. ABS AND THE RESPONSE TO THE FINANCIAL CRISIS OF 2008: THE DODD-FRANK ACT AND 17 C.F.R. § 229.1111 AND § 230.193

In the wake of the Financial Crisis of 2008, the United States government looked to restore responsibility and accountability to the United States financial system.⁷² The government decided to take certain measures with the motivation of restoring Americans' confidence in the United States' financial system.⁷³ Through the Dodd-Frank Act, Congress and the Securities and Exchange Commission made profound increases in the regulation of the financial

⁶⁷ See Nguyen, *supra* note 6, at 11-12 (stating start-up companies face a small chance of success).

⁶⁸ Gompers, Paul A., Kovner, Anna, Lerner, Josh and Scharfstein, David S., *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs* (July 2006) (unpublished manuscript) available at <http://ssrn.com/abstract=933932>.

⁶⁹ *Id.*

⁷⁰ *A Start-Up's Financing Strategy*, HIGHLAND CAPITAL PARTNERS, http://www.hcp.com/startup_financing_strategy (last visited Oct. 9, 2011).

⁷¹ *Id.*

⁷² STAFF OF THE U.S. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 111TH CONG., BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

⁷³ *Id.*

industry.⁷⁴ Two mechanisms used in an attempt to establish additional regulation of the financial industry are 17 C.F.R. § 229.1111 and § 230.193.⁷⁵ Both of these regulations deal with the requirements an issuer of an ABS must perform prior to issuing an ABS.⁷⁶ An issuer of an ABS pursuant to § 229.1111 and § 230.193 must perform a review of the assets underlying the ABS and disclose the nature of the review.⁷⁷ Essentially, the new rules for ABS shift to a public-style disclosure with ongoing reporting.⁷⁸ The new rules demand that most ABS be accompanied with loan-level disclosure.⁷⁹ More explicitly, an issuer of an ABS must disclose standardized, specific asset-level information concerning each asset underlying the ABS.⁸⁰ This disclosure not only must occur at the time of the issuance of the ABS, but also on an ongoing basis.⁸¹ Moreover, the required information on the underlying asset, regardless of the asset type, consists of approximately twenty-eight general fields and additional specified fields for particular asset types.⁸² Thus, the rules, in particular § 229.1111, attempt to bolster the previous regulation governing ABS, Regulation AB.⁸³

The new regulations coming from the Securities and Exchange Commission (“SEC”) significantly heighten the reporting requirements for any entity considering issuing an ABS. The depth and amount of information that will now be necessary for any ABS

⁷⁴ See Eric J. Friedman, *Dear Clients and Friends Introduction to WILLIAM J. SWEET ET AL., SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, THE DODD-FRANK ACT COMMENTARY AND INSIGHTS* (July 12, 2010), http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf.

⁷⁵ 17 C.F.R. § 229.1111 (2011); 17 C.F.R. § 229.193 (2011).

⁷⁶ Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231, 4231 (Jan. 25, 2011) (codified at 17 C.F.R. pts. 229, 230), *available at* <http://www.sec.gov/rules/final/2011/33-9176fr.pdf>.

⁷⁷ *Id.*

⁷⁸ J. PAUL FORRESTER, PAUL A. JORISSEN, JASON H.P. KRAVITT & STUART M. LITWIN, MAYER BROWN, SUMMARY OF THE US SEC’S ABS RULE CHANGE PROPOSAL 3 (Apr. 21, 2010), <http://www.mayerbrown.com/publications/article.asp?id=8892&nid=6>.

⁷⁹ CHARLES E. BRYAN ET AL., CADWALADER, WICKERSHAM & TAFT LLP, CLIENTS & FRIENDS MEMO: SEC PROPOSES SIGNIFICANT ENHANCEMENTS TO REGULATION OF ASSET-BACKED SECURITIES 1 (Apr. 20, 2010), http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf.

⁸⁰ *Id.* at 10.

⁸¹ *Id.*

⁸² *Id.*

⁸³ See Jonathan Rusch, *Securities: SEC Issues Final Dodd-Frank Rules Relating to Asset-Backed Securities*, NOTICE AND COMMENT (Feb. 17, 2011, 9:29 AM), <http://regulatorypractice.blogspot.com/2011/02/securities-sec-issues-final-dodd-frank.html>.

will have substantial ramifications for start-up businesses with a majority of assets related to IP, particularly businesses attempting to issue a patent ABS. The most drastic consequence of the new regulations to start-up businesses with a majority of assets related to IP will be the additional costs that must now be incurred to engage in a patent ABS. In fact, the SEC contemplated this outcome in its release of 17 C.F.R. parts 229 and 230. The SEC stated:

“[a]lthough issuers of ABS likely already perform some level of review of the underlying assets and many originators review the assets at origination, ABS issuers in registered offerings may incur additional costs to perform more extensive reviews that are sufficient to comply with the minimum level of review required by the rule”⁸⁴

Thus, for start-up firms with a majority of assets related to IP, one of the primary advantages of engaging in ABS financing will be eliminated.⁸⁵ Furthermore, if these start-up firms are in high-technology industries, the time required to accumulate the information necessary to meet the disclosure requirements and to ensure the continual compliance with the disclosure requirements may also inhibit the issuing of patent ABS. The reality is that, after these new regulations, issuing and maintaining a patent ABS will take considerably more time and effort and could prevent this financial vehicle from being a strategically viable option for these start-up companies.⁸⁶ In the high-technology competitive environment, where a rapid growth curve is essential and competitors strategically leverage capital to accelerate progress, increasing the duration it takes to issue a patent ABS can make obtaining a patent ABS an unrealistic option.⁸⁷ Ultimately, the start-up entity is left with less flexibility in financing options as a result of the SEC’s regulations.

However, the SEC’s regulations do allow an issuer to use a third party to perform the mandatory reviews with an ABS.⁸⁸ This alternative has the potential to make the issuing of a patent ABS more feasible. By drawing on the expertise and resources of a third party

⁸⁴ Issuer Review of Assets in Offerings of Asset-Backed Securities, *supra* note 76, at 4241.

⁸⁵ See Nguyen, *supra* note 6, at 13-16; see also *Financial Concepts: The Risk/Return Tradeoff*, *supra* note 42; see also Interview by David Wanetick, *supra* note 54.

⁸⁶ See *A Start-Up’s Financing Strategy*, *supra* note 70.

⁸⁷ See *id.*

⁸⁸ Issuer Review of Assets in Offerings of Asset-Backed Securities, *supra* note 76, at 4242.

reviewer, the start-up firm could solve the cost and time issues associated with pursuing a patent ABS with the SEC's new rules. However, there are certain requirements that may deter a third party from conducting the necessary reviews. The deterrence would be even more prevalent for a patent ABS. The reason for this deterrence is that the third party is required to be named in the ABS's registration statement as an expert.⁸⁹ Many third party reviewers will refuse to expose themselves to the liability associated with being named in the reviews as an expert.⁹⁰ Additionally, the asset class of patents may not even have third parties available to do the reviews.⁹¹

A. SEC Regulations and the Benefits They Are Supposed to Provide for Patent ABS

With the considerable curtailment of the attractiveness to start-up companies of issuing a patent ABS, the key question becomes: what benefits can be derived from the SEC's new regulations regarding patent ABS? By requiring more reviews and more thorough reporting of the underlying assets of the ABS, the regulations are attempting to improve the asymmetric information exchange surrounding an ABS. Asymmetric information exchange involves instances where an individual or entity possesses information that the other party cannot verify or is unable to access.⁹² Fundamentally, asymmetric information relates to quality and uncertainty.⁹³ In considering the concept of asymmetric information, economist George A. Akerlof analyzed buyers and sellers in the used automobile market.⁹⁴ Through his examination, Akerlof proposed that a seller would gain a good idea of the quality of the machine after owning it for a length of time.⁹⁵ Therefore, an asymmetry of available information develops.⁹⁶

A related problem that is created by the existence of asymmetric information is adverse selection.⁹⁷ At the heart of adverse selection is the situation where an individual does business with another person

⁸⁹ *Id.*

⁹⁰ *See id.*

⁹¹ *See id.*

⁹² JAMES R. MCGUIGAN ET AL., *MANAGERIAL ECONOMICS APPLICATIONS, STRATEGY, AND TACTICS* 368 (Jack W. Calhoun et al. eds., 12th ed. 2011).

⁹³ George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *THE Q. J. OF ECON.* 488, 488 (1970).

⁹⁴ *See id.* at 489.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *See* Gregory Lewis, *Asymmetric Information, Adverse Selection and Online Disclosure: The Case of eBay Motors*, 101 *AM. ECON. REVIEW* 1535, 1535 (2011).

that in reality he would be better off avoiding.⁹⁸ A good example portraying the interaction of asymmetric information and adverse selection can be found in the insurance industry (another market typically used to explain asymmetric information). Generally, insurance premiums are set according to the average risk associated with a group of individuals that meet chosen criteria.⁹⁹ For instance, the criteria could be males between the age of 60 and 65 who have diabetes.¹⁰⁰ As a result of asymmetric information, the individuals considering purchasing an insurance policy know if they have a lower or higher risk of needing to claim the insurance.¹⁰¹

The adverse selection results in individuals that have knowledge that they will be more likely to claim the insurance will likely purchase the insurance.¹⁰² Meanwhile, many of the individuals that have the knowledge they will be less likely to claim the insurance will view the premium of the policy as being costly.¹⁰³ Therefore, the premiums set to coordinate with the average risk of the group will not be adequate to cover the claims that will arise under the plan.¹⁰⁴ This is a result of the predominance of individuals who purchased the plan having a higher likelihood of needing to claim the insurance.¹⁰⁵ Raising the price of the insurance policy will not get the insurance company out of this predicament.¹⁰⁶ This is due to the fact that the price increase makes the policy even more unattractive to those who possess the information that they have a lower risk of needing to claim on the insurance policy.¹⁰⁷ Consequently, the insurance company is left with a situation of adverse selection as defined as “a limited choice of lower-quality alternatives attributable to asymmetric information.”¹⁰⁸ Thus, because of the presence of asymmetric information, the insurance company is unable to accurately assess the risk of the policy and, consequently, unable to accurately price the premium.

In the financial markets, the asymmetric information derives from a security holder or originator of a security not being able to credibly

⁹⁸ *Adverse Selection*, THE ECONOMIST, <http://www.economist.com/economics-a-to-z> (last visited Feb. 18, 2011).

⁹⁹ *See id.*

¹⁰⁰ *Id.* (using the age of 55 and smoking).

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ MCGUIGAN ET AL., *supra* note 92, at 371.

reveal its intrinsic value to a potential buyer.¹⁰⁹ In securitization, the available information is substantially on the side of the market that produced the financial structures.¹¹⁰ Accordingly, the asymmetric information about the true value of the asset generates an issue where the buyer is uncertain about the true purpose for the seller to sell the security.¹¹¹ The buyer is not in a position to know for certain whether the seller is motivated to sell the security because of a need for liquidity or if the seller is trying to dispose of toxic assets.¹¹² Essentially, the asymmetric information about the actual value of the asset generates the “lemons problem” that Akerlof proposed in his research.¹¹³ In analyzing the used automobile industry, Akerlof considered a market in which goods are sold honestly or dishonestly and the quality of the goods could be accurately represented or inaccurately represented.¹¹⁴ Akerlof believed that the presence of people in the market who are willing to offer inferior goods, or lemons, is likely to drive the market out of existence.¹¹⁵ Akerlof noted that the market being driven out of existence is the major cost of dishonesty because dishonest transactions in the market typically drive out the honest transactions.¹¹⁶ Consequently, the buyers in the financial market will be left with a situation of adverse selection because the only financial offerings will be the “lemons.”¹¹⁷ Moreover, most economists are in accordance that a market with asymmetric information is usually not operating at an optimal efficiency.¹¹⁸

B. Why the SEC Regulations Do Not Provide Significant Benefits to Patent ABS

The new regulations imposed by the SEC compelling more review

¹⁰⁹ Discussion Paper, Daniel O. Beltran & Charles P. Thomas, Bd. of Governors of the Fed. Reserve Sys., *Could Asymmetric Information Alone Have Caused the Collapse of Private-Label Securitization?* 5 (Oct. 2010) (International Finance Discussion Paper #1010), *available at* <http://www.federalreserve.gov/pubs/ifdp/2010/1010/ifdp1010.pdf>.

¹¹⁰ *Id.*

¹¹¹ *See* Koralai Kirabaeva, *The Role of Adverse Selection and Liquidity in Financial Crisis* 2-3 (Sept. 2009) (unpublished note), *available at* <http://economics.cornell.edu/cae/conferences/Koralai.Kirabaeva.pap.pdf>.

¹¹² *Id.*

¹¹³ *See id.*; *see also* Akerlof, *supra* note 93, at 495.

¹¹⁴ Akerlof, *supra* note 93, at 495.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *See* Kirabaeva, *supra* note 111, at 3.

¹¹⁸ DENNIS W. CARLTON & JEFFERY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 445-46 (Prentice Hall, 4th ed. 2005).

and disclosure of the underlying asset in an ABS aims to curtail situations of adverse selection resulting from asymmetric information. However, it is questionable whether these regulations will accomplish the purpose for which they were enacted. Regarding start-up companies that predominately have their assets tied to intellectual property, the key consideration is how much the asymmetric information gap can be closed and how prevalent the information is in the patent ABS market, pushing the market towards adverse selection.

1. The Difficulties in Valuing the Patent

It would be difficult to refute an assertion that the start-up entity would have more knowledge of the underlying patent or patents in an ABS structure. Yet, the extent to which this knowledge can lead to adverse selection is limited. The reason for this is the difficulty in valuing the underlying patent or patents. Valuing IP assets is a difficult task because their true value may not be readily apparent.¹¹⁹ One of the significant elements that contributes to the uncertainty of the value of IP is related to the fact that much of the value of an IP asset resides in the negative right to prevent others from doing something they otherwise would be allowed to do.¹²⁰ For instance, in valuing a company's patent portfolio, the portfolio may have the greatest value in permitting the company to conduct its business devoid of any concerns of infringement it may otherwise face from third-parties.¹²¹ As well, valuing any IP asset can be further complicated by the fact the value is sometimes not static.¹²²

2. Lack of Standardization for Valuing Patents and IP

Another complicating factor in attempting to accurately assess the value of any IP asset is the absence of any standardization in IP valuation.¹²³ In contrast to valuing a business, which has fairly detailed standards for valuation, IP has no standards delineating the unique factors that must be analyzed when valuing IP.¹²⁴ In fact, it has been estimated that there are more than fifty different methods in use

¹¹⁹ Jody C. Bishop, *The Challenge of Valuing Intellectual Property Assets*, 1 NW. J. TECH. INTELL. PROP. 59, 62 (2003).

¹²⁰ *See id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *See* J. Timothy Cromley, *Intellectual Property Valuation Standards*, INTELL. PROP. TODAY, Jan. 2007, at 36, 36, available at <http://www.iptoday.com/pdf/2007/1/Cromley-Jan2007.pdf>.

¹²⁴ *Id.* at 37.

to value IP.¹²⁵ A significant reason that so many methods exist is the fact that there are a myriad of IP valuers each with different backgrounds and professional training.¹²⁶ The IP valuation community encompasses individuals trained in accounting, economics, and finance, each with its own perspective.¹²⁷ However, a standard for IP valuation developed around any one of the particular perspectives could be entirely wrong for certain contexts.¹²⁸ Standards developed around a particular perspective would most likely be skewed or inadequate.¹²⁹

It is into this environment that start-up businesses with most of their value associated with IP are thrust when attempting to embark on a patent ABS. Even the start-up firm in possession of the patent is highly susceptible to inappropriate valuations and a lack of understanding of the valuation process.¹³⁰ Thus, the start-up entity can be prone to inequities relating to the value of the core asset, the patents.¹³¹ Fundamental to the valuation issues and challenges facing start-up businesses is the inability to establish a benchmark to assist in reducing the subjectivity of any valuation.¹³² It is difficult to establish a benchmark because of the nature of the asset being used. The valuation of IP flows from assumptions about the potential business opportunities to derive future revenue streams or develop markets.¹³³ This results in the inability to have certainty on which to base any valuation. Additionally, because of the innovative aspect of IP, IP valuation is often tied to the creation of new products, technologies, and markets.¹³⁴ Thus, it can be extremely difficult and costly to obtain comparable information.¹³⁵

With these circumstances surrounding a start-up business's valuation of any patent it would use in an ABS, as well as the harm the SEC's regulations could cause, it does not comparatively appear that

¹²⁵ Patrick H. Sullivan, *Standardising IP Valuations: Whether, What and How*, INTELL. ASSET MGMT., Mar.–Apr. 2009, at 31, 31 *available at* <http://www.iam-magazine.com/issues/Article.ashx?g=9f642daa-7202-4f9a-8b4d-690a54768ee9>.

¹²⁶ *See id.* at 33.

¹²⁷ *See id.* at 32–33.

¹²⁸ *See id.* at 32.

¹²⁹ *Id.* at 35.

¹³⁰ *See* Leanne McDonald & Ruth Drinkwater, *Realistic Valuations of Intellectual Property Methods and Techniques for Valuing IP*, AUSTL. INST. FOR COMMERCIALISATION, Aug. 2004, at 1, 4, *available at* http://www.ausicom.com/filelib/Realistic_Valuations_of_IP_-_RG.pdf.

¹³¹ *Id.*

¹³² *Id.* at 7.

¹³³ *Id.* at 8.

¹³⁴ *Id.* at 8.

¹³⁵ *Id.* at 8.

the gap of asymmetric information will be significantly reduced. As a result of this lack of IP valuation standardization and the considerable impediments start-up businesses face in coming to an accurate appraisal of the patent, combined with the detriments of the regulations, it appears as though the regulations will have a minimal effect on the difference in asymmetric information between buyers and issuers of patent-based ABS.¹³⁶ This gap closure seems especially minimal when compared to the potential negative effects of the regulations, which will soon be discussed.

Furthermore, the start-up business's unique nature and position necessitating the desire to issue a patent ABS assuages the concern over whether the business is attempting to rid itself of toxic assets.¹³⁷ The overriding motivation for the start-up engaging in the patent ABS is the need for liquidity.¹³⁸ Also, because the companies are start-ups, they will likely need to go back to the markets to gain more financing.¹³⁹ It follows that the start-up company will need to maintain a good reputation to procure more financing.¹⁴⁰ This would prevent the start-up company from dumping toxic assets. In light of these considerations, it becomes apparent that with patent ABS, the SEC regulations will not confer the amount of benefits that motivated the issuing of the regulations. The heightened requirements of reviewing and reporting the underlying patent will not significantly limit the adverse selection because the start-up businesses already have deterrents from dumping toxic assets through patent ABS.

V. THE NEGATIVE EFFECTS ON INNOVATION AND THE AMERICAN ECONOMY

The minimal benefits that will be derived from the SEC regulations for patent ABS must be weighed against the negative

¹³⁶ See generally Beltran & Thomas, *supra* note 109 (stating in securitization most of the information is on the side of the seller).

¹³⁷ See generally Kirabaeva, *supra* note 111 (stating buyers do not know whether seller is selling because he needs liquidity or is attempting to get rid of toxic assets).

¹³⁸ See Kalanje, *supra* note 48.

¹³⁹ See George C. Levy & Thomas S. Vaughn, *How to Finance Your Startup*, CREATIVE CAPITAL ASSOCIATES, <http://www.ccassociates.com/factoring-e-learning-center/how-to-finance-your-start-up> (last visited Jan. 31, 2012) (noting how start-ups should determine how much money they will need now and later and how start-ups always need more money).

¹⁴⁰ See KEVIN T. JACKSON, BUILDING REPUTATIONAL CAPITAL 1 (2004) (stating reputational capital as the most powerful force behind a business and discussing its ability to be leveraged for strategic advantage and long-term financial performance).

ramifications resulting from the regulation's hindrances for creating this financial vehicle. The most significant negative effect the regulations will have pertains to the American economy. The American economy and American businesses have shifted towards being heavily dependent on IP. In 2005, it was estimated that the copyright industry and the output of patent intensive industries accounted for 9.2 percent of the U.S. GDP.¹⁴¹ This estimate excludes industries that are not considered traditional IP sectors, but still produce goods or services that draw their value heavily from the use of IP.¹⁴² Furthermore, it has been suggested that intangibles can be held responsible for seventy percent of the current value of equities in the United States.¹⁴³ These facts coincide with the replacement of the brick-and-mortar economy with the economy of ideas.¹⁴⁴ In the economy of ideas, wealth is developed through generating and capturing the value of knowledge.¹⁴⁵ Thus, innovative thinking is as valuable as skill.¹⁴⁶ A firm's innovative thinking and innovative knowledge management leads to intellectual capital.¹⁴⁷

A. The American Recovery and Reinvestment Act

The importance of innovation to the vitality of the American economy is further evidenced by looking at the recently passed, "The American Recovery and Reinvestment Act" ("The Recovery Act").¹⁴⁸ A report issued by the White House discussing the reinvestment portion of The Recovery Act emphasized transforming the American economy through innovation.¹⁴⁹ The report on The Recovery Act emphasizes innovation, noting how the United States, as a leader in discovery and innovation, has been able to change the way the world thinks about government, industry, and technology.¹⁵⁰ It follows that one of the objectives of The Recovery Act is to invest in the building

¹⁴¹ SHAPIRO & HASSETT, *supra* note 29, at 12.

¹⁴² *Id.* at 12.

¹⁴³ *Id.* at 13.

¹⁴⁴ See KAMIL IDRIS, WORLD INTELL. PROP. ORG., INTELLECTUAL PROPERTY A POWER TOOL FOR ECONOMIC GROWTH 55 (2003), available at http://www.wipo.int/export/sites/www/about_wipo/en/dgo/wipo_pub_888/pdf/wipo_pub_888_chapter_3.pdf.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 56.

¹⁴⁷ *See id.*

¹⁴⁸ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

¹⁴⁹ THE WHITE HOUSE, *The Recovery Act, Transforming the American Economy Through Innovation: Introduction*, <http://www.whitehouse.gov/recovery/innovations/introduction-innovation> (last visited Feb. 22, 2012).

¹⁵⁰ *Id.*

blocks of American innovation.¹⁵¹

B. The Key Relationship Between Patents and Innovation

In particular, patents play an increasingly vital role in innovation and economic performance.¹⁵² Patents can be used to stimulate economic development by facilitating technology transfer and investment and being a catalyst for new technologies and businesses.¹⁵³ Markets for technology are becoming more essential to the circulation of knowledge.¹⁵⁴ In the market for technology, patents are positioned in a pivotal role for the development of technology transactions.¹⁵⁵ Additionally, patents are a powerful tool for stimulating ventures into innovations that could lead to new technologies and industries.¹⁵⁶ Patents provide a mechanism that drives innovation by allowing inventors to profit from their inventions.¹⁵⁷

The increased standards of review and reporting required by the new SEC regulations for patent ABS can have dire consequences to the innovation that is a key factor to the health of the United States economy. The regulations will significantly limit a critical financial option for start-up companies with most of their value tied to IP. These small start-up companies with the predominant amount of their value associated with IP have enormous potential to inject innovation into the American economy through their patents.¹⁵⁸ A start-up company with a dominant portion of its value vested in IP is able to more easily innovate, especially regarding disruptive technologies, because it is not held down by outdated values or organizational norms.¹⁵⁹ However, if patent ABS, and more broadly IP ABS, are

¹⁵¹ *Id.*

¹⁵² ORG. FOR ECON. CO-OPERATION AND DEV., PATENTS AND INNOVATION: TRENDS AND POLICY CHALLENGES 5 (2004), available at <http://www.oecd.org/dataoecd/48/12/24508541.pdf>.

¹⁵³ See SHAPIRO & HASSETT, *supra* note 29, at 2-3, 8, 9.

¹⁵⁴ ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 152.

¹⁵⁵ *Id.*

¹⁵⁶ See SHAPIRO & HASSETT, *supra* note 29, at 8.

¹⁵⁷ ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 152, at 9.

¹⁵⁸ See generally Ron Ashkenas, *Can a Big Company Innovate Like a Start-Up?*, HARV. BUS. REV. BLOG NETWORK (Jan. 25, 2011, 2:05 PM), <http://blogs.hbr.org/ashkenas/2011/01/can-a-big-company-innovate-lik.html>.

¹⁵⁹ CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL 208-09 (1997); see also Eric Ries, *A Startup Inside a Fortune 500 Company? The Nordstrom Innovation Lab*, HUFFPOST BUS. (Nov. 04, 2011, 7:20 PM), http://www.huffingtonpost.com/eric-ries/a-startup-inside-a-fortun_b_1068449.html (stating how after one reads *The Innovator's* continued . . .

subjected to the SEC's new regulations, the United States economy will likely lose out on the opportunity to reap the benefits of the innovation derived from patents of start-up companies. As innovation is a principal driver of long-term economic growth and prosperity, this loss of opportunity would have significant consequences for the economy of the United States.¹⁶⁰ By comparing the minimal benefits that will be derived from including IP ABS and particularly patent ABS in the stipulations of the regulations of the SEC, it is apparent that the financial vehicles of IP ABS and patent ABS should be excluded from the regulations' requirements.

In allowing the patent ABS and overarching IP ABS to be exempt from reporting and reviewing requirements of the SEC's provisions, the American economy will be heeding renowned economist Paul Romer's keys to economic growth.¹⁶¹ As Romer states, "economic growth doesn't arise just from adding more labor to more capital, but from new and better ideas expressed as technological progress."¹⁶² Many of the novel and useful ideas will come from the innovative patents of start-up companies with significant assets of IP. Hence, the American economy will have a remarkably better chance to grow if those start-up companies are given the tools needed to survive and prosper.

C. Apple and the Innovation From Its Patents' Effect on the American Economy

Consider the case of Apple, its patents and the innovation it has brought to the United States economy. Apple is unique in that it has grown into a large and global company yet has been able to maintain the culture of a start-up business.¹⁶³ In fact, Apple, despite being in business for thirty-five years, still makes a conscious effort to conduct itself in the manner of a start-up business.¹⁶⁴ Professors and

Dilemma one knows how hard it can be for a company that has been successful to invest in disruptive technologies).

¹⁶⁰ See THE WHITE HOUSE, *supra* note 149 (stating innovation as a key driver of long-term economic growth and prosperity).

¹⁶¹ See generally Ronald Bailey, *Post-Scarcity Prophet Economist Paul Romer on Growth, Technological Change, and an Unlimited Human Future*, REASON.COM, Dec. 2001, available at <http://reason.com/archives/2001/12/01/post-scarcity-prophet/singlepage>.

¹⁶² *Id.*

¹⁶³ See Nilofer Merchant, *Apple's StartupCulture*, BLOOMBERG BUSINESSWEEK (June 14, 2010, 2:51 PM), http://www.businessweek.com/innovate/content/jun2010/id20100610_525759.htm.

¹⁶⁴ Adam Lashinsky, Jr., *How Apple Works: Inside the World's Biggest Startup*, FORTUNE, Aug. 25, 2011, at 132, available at <http://tech.fortune.cnn.com/2011/08/25/how-apple-works-inside-the-worlds-biggest-startup>.

researchers Greg Linden, Jason Dedrick, and Kenneth Kraemer analyzed innovation and job creation through Apple's iPod.¹⁶⁵ Through considering the extent innovation from American companies will have a beneficial effect on American workers, the three professors and researchers analyzed the global value chain that designs, builds, and brings iPods to consumers.¹⁶⁶ The analysis of the global value chain was broken down by examining which countries capture the financial value within the global value chain and how innovation can influence jobs and wages.¹⁶⁷ As a result of the findings, the professors and researchers argue that in the environment of a globalized economy, industries driven by innovation disproportionately benefit the American worker and the United States economy.¹⁶⁸ The report concluded that, notwithstanding the fact the product is produced overseas, innovative products designed by companies in the United States create valuable jobs in America.¹⁶⁹ In reality, the report noted that China, where the iPod is assembled, was not able to capture much of the financial value created by Apple's global value chain.¹⁷⁰

It can be concluded that Apple has become an integral part of the United States economy. As recently as this past July, Apple had amassed a cash pile of \$75.87 billion.¹⁷¹ This stockpile of cash actually exceeded the amount the United States government had in its reserves by \$2.11 billion.¹⁷² This is not to say that every start-up company will develop into a company of the magnitude of Apple. However, Apple embodies the potential that many start-up companies with the dominant portion of their value related to IP can reach. Many of these start-up companies are capable of developing groundbreaking innovative products and technologies through their patents that may not rise to the caliber of Apple, but still can have significant positive effects on the American economy and American work force. It is the potential for innovation and economic stimulus that outweighs the

¹⁶⁵ Greg Linden et al., *Innovation and Job Creation in a Global Economy: The Case of Apple's iPod*, UNITED STATES INT'L TRADE COMM'N J. OF INT'L COMMERCE & ECON., May 2011, at 223 (2011), available at <http://pcic.merage.uci.edu/papers/2011/InnovationJobCreationiPod.pdf>.

¹⁶⁶ *Id.* at 224.

¹⁶⁷ *Id.* at 226.

¹⁶⁸ Alex Wagner, *Apple's iPod: The Case for the Innovation Economy*, HUFFPOST BUS. (Sept. 25, 2011, 07:37 PM), http://www.huffingtonpost.com/2011/06/08/apple-ipod-innovation-economy_n_873336.html.

¹⁶⁹ Linden et al., *supra* note 165, at 231.

¹⁷⁰ *Id.* at 226.

¹⁷¹ *Apple Is Richer than US Government*, THE TIMES OF INDIA (July 29, 2011, 01:58 PM IST), <http://timesofindia.indiatimes.com/tech/news/hardware/Apple-is-richer-than-USgovt/articleshow/9407704.cms?prtpage=1>.

¹⁷² *Id.*

minimal benefits that would be garnered from including patent ABS and the broader IP ABS in SEC regulations § 229.1111 and § 230.193. The impediments created by the SEC's new rules should be removed in order to allow start-up entities with valuable IP to procure essential funding.

VI. HOW CARVING OUT PATENT ABS AND THE BROADER IP ABS CAN HELP THE SEC REGULATIONS

However, the claim should not be made that patent ABS and the overarching IP ABS should never be held to the reporting and review requirements of the SEC's new provisions. By not including patent ABS and IP ABS under the purview of the regulations, the SEC may be helping the regulations to be more beneficial to patent ABS and IP ABS in the future. As discussed earlier, one of the most important benefits the new reporting and reviewing rules look to confer is closing the gap of asymmetric information in the market and limiting the market movement towards situations of adverse selection.¹⁷³ Yet, because of the limitations of IP valuation and deterrents for dumping toxic assets, closing the gap of asymmetric information in the market and preventing a driving movement towards adverse selection will not outweigh the negative effects of the measures taken to accomplish these goals.¹⁷⁴ Through not including patent ABS and IP ABS in the parameters of § 229.1111 and § 230.193, there will not be the concern that the regulations are too onerous and the IP ABS and patent ABS will not be issued in the market. Thus, the IP valuation community will not have to be concerned about having less data, information, and comparables in the public marketplace to aid in developing valuation standards.¹⁷⁵

More IP ABS, and particularly patent ABS, can be issued if the constraints of the SEC's regulations are not imposed.¹⁷⁶ Accordingly, having more of these IP derived financial vehicles will give the IP valuation community more material through which it can move to more standardization. The patent ABS and overall IP ABS can provide more opportunities to develop and potentially put into practice

¹⁷³ See *supra* text following note 118.

¹⁷⁴ See *supra* text accompanying notes 136-37.

¹⁷⁵ See Terrence Hendershott & Charles M. Jones, *Island Goes Dark: Transparency, Fragmentation, and Regulation*, 18 REV. FIN. STUD. 743, 744 (2005) (discussing the SEC's requirement of Island electronic communications network to comply with Regulation ATS motivating Island to go "dark" and causing trading and price discovery to be conducted at much lower levels).

¹⁷⁶ Issuer Review of Assets in Offerings of Asset-Backed Securities, *supra* note 76, at 4241-42.

key standardization principles related to creating a common language and terminology with IP valuation.¹⁷⁷ Often, terms used in the valuation of IP are not applied in a uniform manner and are undefined, ambiguous, or are unique to the particular area of business or industry.¹⁷⁸ The patent ABS and overall IP ABS can provide more mechanisms to discern how any valuation standardization system would need to function to best operate in the world of business. For instance, the Business Valuation Standards Committee of the American Society of Appraisers commissioning of the Intellectual Asset Valuation Standards (“IAVS”) subcommittee to develop standards for the valuation of intangible assets provides a compelling circumstance for patent ABS and the broader IP ABS.¹⁷⁹ A stronger existence of IP ABS, and specifically patent ABS, could bestow more insight into how the standards the IAVS has generated will be able to address the challenges and needs of structuring IP valuation to have substance and specificity, but not be mired in the multiplicity of IP.¹⁸⁰

Ultimately, the presence of IP ABS, and more applicably patent ABS, and the way they operate offers a lens into how IP should be valued. They can help to gain a better understanding of the nature and fundamentals of IP. This understanding can be combined with ventures like Ocean Tomo’s IP Exchange and the Intellectual Property Exchange International.¹⁸¹ These ventures look to enhance efficiency, transparency, and to deepen understanding of innovation in the economy.¹⁸²

¹⁷⁷ See Sullivan, *supra* note 125, at 33.

¹⁷⁸ See *id.*

¹⁷⁹ See Cromley, *supra* note 123, at 37.

¹⁸⁰ See *id.*

¹⁸¹ Dennis Crouch & Jason Rantanen, *Ocean Tomo’s IP Exchange (IPX)*, PATENTLYO (Apr. 17, 2001), http://www.patentlyo.com/patent/2007/04/ocean_tomos_ip_.html; *Welcome to the Intellectual Property Exchange International, The World’s First Financial Exchange Focused on Intellectual Property (IP) Right*, IPX INT’L, <http://www.ipxi.com> (last visited Feb. 23, 2012).

¹⁸² See *id.*