

A Proposal to Remove Uncertainty from Claims of Small Entity Status Before the USPTO by Correcting and Enhancing SBA and USPTO Regulations

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Small businesses are an essential component to the U.S. economy, employing about half of the nation's private sector workforce and creating most of the nation's new jobs. Particularly in emerging industries, small businesses provide a significant share of technological innovation, reflected in quality patents.¹

Recognizing that high costs of obtaining patents should not discourage the significant innovative contributions of small business concerns, Congress allowed all small business concerns to pay reduced patent fees. 35 U.S.C. § 41(h). Today, however, the relief intended for small businesses is undermined by a confusing scheme of outdated regulations that force small business concerns to choose either (1) to risk the enforceability of their patents to obtain their entitled discounts in patent fees or (2) to pay higher fees to eliminate that risk. This article analyzes the history of the statutory and regulatory evolution of the small entity provisions for patenting, identifies a problem in the regulatory scheme, and offers a solution that would streamline determinations of small entity status: the elimination of any separate definition of a "small business" for paying reduced patent fees other than the basic definition in the Small Business Association's ("SBA") small business statute and generally applicable regulations.

The Benefits and Pitfalls to Claims of Small Entity Status

Under 35 U.S.C. § 41(h), a small business concern is entitled to a 50% discount on patent application fees, patent issue fees, and maintenance fees "to soften the impact of [patent] fee increases . . . upon those who are least able to absorb the increased fees without overall damage to their ability to participate in the patent system through the filing, issuing and maintaining of patents." 47 Fed. Reg. 40135 (Sept. 10, 1982); see also Manual of Patent Examining Procedure ("MPEP") § 509.03 (8th ed. rev. 7, July 2008).

The U.S. Patent and Trademark Office ("USPTO") implements the discount as a self-certification program, declining to give advisory opinions or otherwise assist in an applicant's determination of whether it can properly claim small entity status.² *Id.* All an entity needs to do to claim entitlement to the fees is to inform the USPTO of its choice and pay the lower fees after determining for itself whether the claim would be proper.

In the USPTO's view, if there is doubt, the applicant should pay more. The MPEP cautions small entity filers to be wary about

taking the fee discount: "[S]mall entity status must not be claimed unless the person or persons [making the assertion to entitlement] can *unequivocally* make the required self-certification." *Id.* (emphasis added).

The lack of guidance from the USPTO underscores the need to have straightforward, bright line tests for determining small entity status. But, as will be explained below, certain provisions of the small entity regulations make unequivocal determination of whether a given small business qualifies as a small business concern no minor task.

Uncertain rules place small businesses in a precarious position, threatening to deny the relief Congress provided. The only time small entity status is scrutinized is when the small entity finds itself in the position of asserting a patent against an infringer for which a small entity fee was paid. When a court finds that small entity status was claimed improperly, the patent may be deemed unenforceable if the court also finds that the claim was made with an intent to deceive the USPTO. 37 C.F.R. § 1.27(h); *Ulead Systems, Inc. v. Lex Computer & Management Corp.*, 351 F.3d 1139, 1146 (Fed. Cir. 2003); *see also Nilssen v. Osram Sylvania*, 504 F.3d 1223 (Fed. Cir. 2007). It can be appreciated that alleged infringers carefully scrutinize claims of small entity status, seeking to place the small business on the defensive. Additional significant amounts of capital may be lost to litigation-related expenses to justify the modest savings in patent fees. *See James Goepel, Small Businesses Aren't Always Small Entities at the USPTO*, *Intell. Prop. Today*, May 2003, at 26.

Therefore, for many patent applicants, the conservative course of action is to forego the small entity discount, eliminating the cost of determining small entity status as well as future litigation costs. Even the USPTO counsels that the effort required to assert small entity status may not be worth the reward:

For some applicants it may be desirable to file as a non-small entity (by not filing a written assertion of small entity status and by submitting non-small entity fees) rather than undertaking the appropriate investigations which may be both difficult and time-consuming and which may be cost effective only where several applications are involved.

MPEP § 509.03 (8th ed., rev. 7, July 2008).

Data from the USPTO support that the small entity regulations discourage many small businesses from taking advantage of their entitlement to reduced fees. The SBA has estimated that 24% of corporate owned patents issued between 1996-2000 belonged to small firms. SBA Office of Advocacy, *Small Serial Innovators: The Small Firm Contribution to Technical Change 10* (2003). Using statistics obtained from the USPTO, the authors estimate that, during that same time period, small entity fees were paid on between 14.5% to 18.2% of patents issued to corporations. Thus, approximately at least one quarter of small business concerns may have chosen to pay large entity fees, resulting in an approximate overpayment to the USPTO on the order of \$10 million per year during that time period. Those small entity regulations will be examined below.

Authorization of Small Entity Regulations

The origins of small entity status at the USPTO lie in Public Law 97-247, which became law on August 27, 1982. Public Law 97-247 permitted the USPTO to increase dramatically the standard fees it charged for patent operations but also allowed small business concerns to pay only half of those standard fees. Congress authorized the SBA to define which business concerns qualified to pay reduced fees. Patent and Trademark Office—Authorizations, Amendments, Schedule of Fees, Pub. L. 97-247, 96 Stat. 317 (1982) ("Funds . . . shall be used to reduce by 50 per centum the payment of fees . . . by small business concerns as defined in section 3 of the Small Business Act *and by regulations established by the Small Business Administration.*" (emphasis

added)).

The SBA regulations, issued with cooperation from the USPTO, defined a "small business concern" for "paying reduced patent fees" as an entity "(1) whose number of employees, including those of its affiliates, does not exceed 500 persons and (2) which has not assigned, granted, conveyed, or licensed, and is under no obligation under contract or law to assign, grant, convey, or license, any rights in the invention to any person who could not be classified as an independent inventor if that person had made the invention, or to any concern which would not qualify as a small business concern or a nonprofit organization under this section." 47 Fed. Reg. 43272-73 (Sept. 30, 1982); 13 C.F.R. §§ 121.3-18 (1982). And, at 37 C.F.R. § 1.9(d) (1982), the USPTO regulations defined a small business concern by explicit reference to the SBA regulations. See 47 Fed. Reg. 40139 (Sept. 10, 1982).

Public Law 97-247, however, expired on October 1, 1985, ostensibly ending the opportunity for small entities to pay reduced fees. See S. Rep. No. 99-305, at 13 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5884, 5896. Congress resurrected the opportunity by enacting Public Law 99-607 § 1(b)(2)—codified as 35 U.S.C. § 41(h). 35 U.S.C. § 41(h) continued to allow (and retroactively allowed) the USPTO to accept lower fees payments from small entities. Pub. L. 99-607, 100 Stat. 3470 (1986); Pub. L. 97-247, 96 Stat. 317; S. Rep. No. 99-305, at 13.

But unlike Public Law 97-247, 35 U.S.C. § 41(h) did not expressly authorize the USPTO or the SBA to issue special "small entity" criteria "for the payment of patent fees." Indeed, Public Law 99-607 did not provide for small business concerns to be "defined in section 3 of the Small Business Act *and* by regulations established by the Small Business Administration," as did Public Law 97-247, but rather provides for small business concerns to be solely "defined under section 3 of the Small Business Act." *Compare* Pub. L. 97-247, 96 Stat. 317 (emphasis added) *with* Pub. L. 99-607, 100 Stat. 3470.

Nevertheless, neither the SBA nor the USPTO reacted to 35 U.S.C. § 41(h) as enacted. No new regulations were promulgated, and no SBA regulations define a small entity pursuant to 35 U.S.C. § 41(h) or Public Law 99-607. Instead, and most tellingly, the SBA regulations that specially define a small business for paying reduced fees, even after streamlining, reference only the expired law. 13 C.F.R. § 121.801-805 (2009) ("These sections apply to size status for the purpose of paying reduced patent fees authorized by Pub. L. 97-247, 96 Stat. 317."); Small Business Size Standards, 61 Fed. Reg. 3286 (Jan. 31, 1996).

On the USPTO's part, it revised its copy of the SBA regulations numerous times over the years.³ Like the SBA, the USPTO continued to reference Public Law 97-247 as being operative, failing to address the differences between expired Public Law 97-247 and 35 U.S.C. § 41(h). See, e.g., 69 Fed. Reg. 56482, 56496 (Sept. 21, 2004) (in response to comment 29: "Public Law 97-247 gave the Small Business Administration (SBA) the authority to establish the definition of a small business concern."); see *also id.* ("35 U.S.C. 41(h) (Public Law 97-247, 96 Stat. 317 (1982)).") Further adding to the complexity of the small entity regime, although the USPTO's regulation (37 C.F.R. § 1.27) reads as if it is the controlling regulation to define a small business entity (to be used in cooperation with the SBA regulations), the USPTO has confirmed that it "does not have the statutory authority to draft its own rules for small business concerns," as that authority lies with the SBA. See *id.* ("the Office does not have the statutory authority to draft its own rules for small business concerns").

The Problem with the Current Regulations

The root⁴ of the disconnect between the number of small entities who seek patents and those that claim a discount is due to the difficulty in making patent-specific assertions of small entity status with certainty.

Under the USPTO's small entity regulation, a small business concern is defined as a business concern meeting the size standards set in SBA regulations 13 C.F.R. §§ 121.801-805—which, *inter alia*, define a small business concern as having no more than 500 employees. The SBA's fixed number of 500 was selected because 500 employees was the SBA size standard "for purposes of research and development" of which "[p]atents are primarily related." 47 Fed. Reg. 38331 (Aug. 31, 1982). Showing that the disconnect in claims of small entity status may not have been accidental, the SBA expressed concern that a different definition of "small business concern" would outstrip "the limited amount of funds authorized to cover the revenue loss from the fee reduction," *id.*, elevating the fiscal needs of the USPTO over the generally applicable standards defining small businesses.

The SBA also implemented another patent-specific hurdle to a claim of small entity status. To qualify as a small business concern, an entity must not have assigned, granted, conveyed, or licensed—and must not have any obligation to assign, grant, convey, or license—(herein, "license") any rights in the invention to a non-small entity, that is, an entity other than another small business concern, a nonprofit organization, or an individual person. 13 C.F.R. § 121.802; 37 C.F.R. § 1.27(a)(2). The provision was intended to, *inter alia*, prevent a "non-small entity [from] transfer[ing] patent rights to a small business concern which would pay the reduced fees and grant an exclusive license to the non-small entity." 47 Fed. Reg. 43275 (Sept. 30, 1982). It is broader than that, however, as non-exclusive, as well as exclusive, licenses are said to be encompassed by the regulation. *Id.*; MPEP § 509.02 (8th ed., rev. 5, Aug. 2006). The USPTO felt any license, exclusive or non-exclusive, signaled that the applicant could "participate" in the patenting process without needing a fee reduction, 47 Fed. Reg. 43272, perhaps reflecting the notion that applications that were commercially successful should not be entitled to a fee reduction. Further, the USPTO was concerned with an "excessive loss of revenue." *Id.*

The USPTO's license provision and, to a lesser extent, the fixed number provision serve to create barriers for small businesses as they not only serve to disqualify small businesses from entitlement to pay reduced fees but also require a unique, patent-specific determination for compliance. For example, the SBA's size standards for small business concerns at 13 C.F.R. § 121.201, which was promulgated pursuant to section 3 of the Small Business Act (15 U.S.C. § 632), define small business concerns by industry (as identified by the North American Industry Classification System Codes), respectively, by annual income receipts, number of employees, and/or amount of assets. Under the SBA size standards, small business concerns in some industries can have more than 500 employees. *Id.* For example, an electronic computer manufacturing business with less than 1001 employees can be considered a small business concern. *Id.* Nevertheless, a small business with 750 employees in this industry cannot pay reduced fees under the patent-specific regulations.

The anti-licensing rule also causes significant uncertainty—and additional required investigation—for small business concerns. The regulation's use of the word "any" in the licensing rule goes far beyond a prophylaxis against shell companies for avoiding patent fees and serves to disqualify small businesses that enter into arm's length transactions with third parties. Compounding the problem, the USPTO's treatment of the patent-specific regulations fail to precisely define what constitutes a disqualifying license. For example, although the regulations speak of "any" license as disqualifying, the MPEP distances itself from that broad language by explaining that certain licenses, such as those incident to the sale of product, are not disqualifying. MPEP § 509.02 (8th ed., rev. 7, July 2008).

Further, while a business could count its own employees to determine compliance with any fixed number limit, the license provision creates problems in that the information needed to determine compliance can be unknown to the business, such as the number of employees of its licensees. Nevertheless, small businesses are tasked to investigate the status of all of their licensees when paying issuance and maintenance fees, the cost of which cuts into the relief provided by the reduced payments.

Accordingly, the current USPTO small entity regulations permit several troubling scenarios. For example, a first small business concern ("SmallCo") with 10 employees may license a patent application to a second small business concern ("GrowingCo") with 490 employees soon after the filing of the application. GrowingCo may grow to 501 employees by the time the patent application is allowed. However, under the current regulations, SmallCo—even if it still has 10 employees—is no longer a small business concern with respect to patent fee payments. Despite that SmallCo may be unaware of the size of GrowingCo, that GrowingCo just barely fails to qualify as a small entity, and that SmallCo is still a small entity under the generally-applicable SBA regulations, under the current USPTO regulations, SmallCo is tasked with monitoring the size of GrowingCo prior to payment of a small entity issue fee.

In another example, a small business concern, SmallCo, has filed provisional patent application A for invention A, and a large business concern ("GiantCo") with 1000 employees may own issued patent B for invention B. SmallCo has determined that it cannot practice invention A without a license to use invention B. Further, SmallCo cannot afford to pay GiantCo licensing fees that GiantCo has charged other entities, but has negotiated a cross-license deal, whereby each entity receives a nonexclusive license to the other's respective invention. Now SmallCo, having licensed invention A to a non-small entity, is perhaps not entitled to pay small entity fees under current USPTO policies, despite that it clearly still is a small entity under the default SBA regulations.

Solutions / Conclusion

Once it is understood that the SBA's patent-specific regulations reference an expired law, it is clear that they present an opportunity for amendment. As discussed above, simply changing the reference in the regulations to the current law, 35 U.S.C. § 41(h), would not solve the practical problems small businesses face when deciding to pay small entity fees. At a minimum, any change should be subjected to debate under proper rulemaking procedures.

The lack of authorization in 35 U.S.C. § 41(h) to issue patent-specific definitions of small businesses can be interpreted to forbid such definitions, particularly as the patent-specific regulations, authorized under an expired law, do not focus on ensuring that small businesses can easily and accurately self-certify small entity status but, instead, seek to have some small businesses overpay to protect the USPTO's revenues. See 47 Fed. Reg. 38331. Congress, however, sought to provide the benefit of reduced fees to *all* small businesses with enactment of 35 U.S.C. § 41(h).

The preferred approach would be to amend the USPTO and SBA regulations to closely track the statutory authorization. Specifically, the regulations should define a small business concern solely with respect to 15 U.S.C. § 632, omitting patent-specific disqualifying provisions such as the current licensing provisions and those setting a limit of 500 employees for *all* industries (under the rubric of an all-encompassing "research and development" industry.)

Striking of the licensing provision, in particular, will allow small entities to enter into beneficial transactions without fear of repercussions for their patent applications. As a matter of fairness, the patent system should encourage small businesses to license their patents rather than punish them for having some success. Further, elimination of the licensing provision will remove significant uncertainty and reduce the investigative burden on licensing small entities. All of the information needed to determine whether a business qualifies as a small entity would be known to the business, allowing it to make a reliable determination as to its status. Armed with such a determination, a small business concern could receive its entitled discount without risk, knowing that the modest savings will not return to haunt it should it seek to enforce the patent in the future.

On the other hand, striking of the licensing provision should not have any effect on the USPTO's mission. The impact of any fee reduction caused by accurate claims of entitlement to small entity status by small businesses should be an issue for USPTO's management, and should not be solved by the expedient of denying small businesses the relief that Congress intended. With regard to the USPTO's goal of preventing large entities from relying on affiliates to avoid paying patent fees, generally applicable SBA regulations already prevent a large business from receiving the small entity discount by simply licensing a patent from a small business under its control. "Concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party . . . controls or has the power to control both." 13 C.F.R. § 121.103(a)(1) (2009). And, "in determining [a] concern's size, SBA counts . . . all of [the concern's] domestic and foreign affiliates." 13 C.F.R. § 121.103(a)(6). Thus, under current—and authorized—SBA regulations, a large business controlling an affiliated small business is prevented from legally paying reduced fees.

Another benefit of an approach that applies generally applicable rules would be to permit patent applicants to apply for a formal SBA size determination from the SBA if there were any doubt regarding the determination and then assert (or not assert) small entity status with legal certainty, practically obviating the potential for related inequitable conduct charges in litigation. This was presumably the intent behind 13 C.F.R. § 121.803, which lacks force due to the USPTO's refusal to advise applicants on whether a claim to small entity status is proper.

In sum, the regulations regarding the reduction of patent fees for small business concerns are uncertain in both viability and practice. The USPTO should act to re-ground small entity fee policy to its statute to ensure relief to small business patent applicants.

Endnotes

¹ SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 1 (2009); Anthony Breitzman, Ph.D., and Diana Hicks, Ph.D., SBA Office of Advocacy, *An Analysis of Small Business Patents by Industry and Firm Size* 23–24, 41 (2008); CHI Research Inc., *Small Firms and Technology: Acquisitions, Inventor Movement, and Technology Transfer* 1 (2004).

² As least theoretically, a small business could ask for a "size determination" from the SBA. 13 C.F.R. § 121.803 (2009); *see also* 37 C.F.R. § 1.27(a)(2)(ii) (2008). In practice, however, it seems unclear whether the SBA would interpret patent-specific issues where the USPTO chooses not to.

³ 37 C.F.R. § 1.9(d) had been amended several times before it was rewritten into 37 C.F.R. § 1.27. 49 Fed. Reg. 34724 (Aug. 31, 1984); 58 Fed. Reg. 54504 (Oct. 22, 1993); 62 Fed. Reg. 53131 (Oct. 10, 1997); 65 Fed. Reg. 54604 (Sept. 8, 2000).

⁴ The reference to an expired law in the SBA's patent-specific regulations theoretically creates uncertainty when determining whether the regulations apply to determination of small entity status. Most applicants, however, seem to follow the USPTO's statements regarding the patent-specific provisions and ignore the reference to the expired law in the SBA regulations.

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