

Intellectual Property And The Entrepreneur: Make Sure You Own What You Think You Own

By

David Jakopac

Vice President, Lisle Technology Partners, LLC

Introduction: Entrepreneurship and Intellectual Property

As an advisor and consultant to entrepreneurs I often come across the following situation: an entrepreneur has a good idea and good market, but does not own the Intellectual Property (IP) at the core of the idea. In this situation, the naïve entrepreneurs dismiss ownership as something that doesn't matter and the clever ones think they can finesse their way around not having it. Neither approach works because both approaches will eventually cause investors to be skeptical and potentially bring unwanted legal action.

The forms that IP can take and ways in which IP can be protected are discussed in the sidebars. This document was not written by an IP attorney and any entrepreneur should consult his or her own legal council for specific legal advice.

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How Is IP Acquired?

If you create an idea, software, documentation or methodologies by yourself, then you have created IP and your concern should be how to protect ownership of the IP. However, if you need some IP that belongs to someone else, how do you acquire it? If it is a patented or licensed work there are two ways: buy it or license it. Buying it transfers ownership and all of its rights, but licensing it can be restricted by agreement and most licensing agreements only allow use of the IP in restricted situations and do not transfer ownership.

There is another way to acquire similar IP that is protected by patent or copyright and that is a technique called building in a *clean room*. Like a semiconductor manufacturing clean room that prevents dust and dirt from getting into the machinery, clean room IP development means that any connection to original IP is not used in construction of the duplicate. This means that you would not use anyone to build the IP that had exposure to data restricted by an NDA, or anyone that saw or incorporated copyrighted material. In the case of a patent you might also have to ensure that it is not functionally equivalent to the original, for

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Patents

Ideas are protect by patents, which cost money to apply for and take time (years) to get approved. The advantage is that they will provide substantial protection against someone who later claims that they had a similar idea. Many times the mere application itself is good enough to provide substantial protection against casual infringers. The value of a patent increases significantly if it has successfully held up on court. So, just having a patent does not mean you will be able to enforce it. Patents are also of value if it turns out you infringed on someone else's patent in a related area. Rather than being restrained from doing business, you may be able to cross license your patents and the ones belonging to the company you have infringed.

There is a limited time between when you first offer a product for sale that incorporates a patentable idea and when the patent application will be accepted for that idea. For the entrepreneur that means that you must be very careful about starting your sales process too soon if you want to be able to patent your ideas. One final note about patents, you must go through extra work and cost if you want them to be upheld internationally. This is especially important today as more and more competition comes from global sources.

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instance by ensuring that your IP greatly improves upon the capabilities of the original in new and creative ways.

Investors and Intellectual Property

Investors are very concerned about the IP rights that a company has, how those rights are protected and what rights of others might be infringed upon. From an IP perspective, an ideal investment would be in a company that has plenty of protected and documented IP that can be differentiated from competitors and can be sold without restrictions if needed. Such a company should also have clear rights to all of its IP and not infringe upon any other company's IP. Especially in today's investment climate, venture capitalists and private investors are eager to find companies that have true IP.

Institutional investors will perform a due diligence before investing and IP rights will be a key feature of that investigation. Many entrepreneurs think that they can wave their hands and finesse their way through the due diligence. Investors worth having will be more aggressive and will not be easily fooled.

Lisle Technology Partners performs technical due diligence for investors and has worked directly with entrepreneurs. The following scenarios are based upon situations that have occurred in the course of that work. In all of these cases, we have either recommended against investment or, if talking directly to an entrepreneur, have recommended that they resolve their IP issues before continuing discussions.

IP Ownership Scenarios That Don't Work

Here is the background for the following scenarios. An entrepreneur has a great product, customers eager to buy and a great background. The problem is that they used to or still do work for a large company called Bigco (a made up company name, not meant to resemble any real company in business or bankrupt) that may have a claim to the entrepreneur's IP.

I'm the inventor of a Bigco patent and they won't do anything with it

The entrepreneur was the inventor of a patented idea that is owned by Bigco. He acknowledges that by his employment agreement Bigco owns the patent, even though he is the inventor. He says that there is nothing to worry about because Bigco has no plans to commercialize the idea behind the patent. (Or, he might point to any number of news items about how Bigco is in financial trouble and must concentrate on its core businesses and technologies.) As in many of these scenarios, the entrepreneur has made some assumptions about the psychology of the management behind Bigco.

Well, the good news is that the idea is protected from infringement by competition. The bad news is that the protection is for Bigco and not for the entrepreneur. The assumption that Bigco does not consider the technology “core” or strategic does



not matter. Bigco paid for the patent filing, they paid the inventor's salary during development and they are periodically paying IP attorneys or their Chief Financial Officer to review IP holdings. These costs ensure that Bigco will be interested in the patent's ownership. If Bigco thinks that the patent protects an idea that they might use in the future or that overlaps or is redundant to their current technology, they will view anyone else's use of the patent idea as competition and the employee's or former employee's use as theft.

This ownership must be worked out before the entrepreneur can take on an investment. Either Bigco must agree to sell or license the patent to the entrepreneur or the entrepreneur must work around not having access to it, say through clean room development.

I did similar work for Bigco, but they don't do this work any more

OK, this one is a bit different. There is no patent involved. No copyrighted material. The entrepreneur worked for Bigco on marketing plans or technologies, but she has since moved on to other work at Bigco and has left to start her own firm. The first question is, what kind of employment agreement was in place at the time she did the work for Bigco?

The entrepreneur might have had no employment agreement or NDA with Bigco. If that is the case then her new company will probably be OK with respect to IP ownership. If our entrepreneur had an agreement with Bigco, but it was specific to topics that have nothing to do with the company she is starting then, again, she is in a good situation. Here is an example of this situation. Our entrepreneur was in sales and had an NDA that covered customer contact information and information regarding Bigco's products. If she starts a company based on an idea that might fix a problem she heard about from those customers, she might be in the clear. Of course, she would be restricted from contacting those customers and the "fix" she has come up with had better not have anything to do with Bigco's products.

However, if our entrepreneur was subject to an agreement that was more restrictive or that clearly covers the creation of her new idea, then the situation has turned ugly. Some agreements go as far as to say that any idea she might come up with is property of Bigco, whether she dreamt it, had a Eureka! moment in the shower, or invented it while on vacation. In this case, she must work out an agreement with Bigco regarding the idea. To believe that Bigco, with such an employment agreement in place, would not be able to claim that they own the idea is wishful thinking. In this case, the entrepreneur must negotiate with Bigco for ownership rights or usage rights to the idea. Some employment agreements may go as far as to claim such rights even after the employee leaves. Your legal council may have some advice on the enforceability of such employment agreements.

Copyright

Copyrights protect written works, not ideas, such as software, books and music. They should be marked appropriately and filed with the U.S. Copyright office to become official copyrighted works (although case law shows that merely marking is has been good enough in some situations). Copyright protection only covers outright copying of the material. This does not protect you from someone who might take the same idea and duplicate the same function as your copyrighted material in a different way. Software programs are sufficiently large these days that to duplicate a popular software product without copying the original source or binary code is very difficult. A "fair use" clause in the copyright law does allow non-copyright holders to make copies of small portions of the material for references, reviews, etc. However, fair use would apply to small portions of software that would not be functional as a whole.



“...Bigco is not going to go after me, I’m just one guy.’ Well, have you ever parked in the CEO’s parking space?”

I did similar work for Bigco, but I’m too small for them to go after

Here is another common story. An entrepreneur says that, “yeah I did similar work for Bigco, but Bigco is not going to go after me, I’m just one guy.” Well, have you ever parked in the CEO’s parking space? You were just one guy then, and yet his administrator called you on the phone and told you not to do it again.

The defense of “being small” doesn’t work for an entrepreneur, because by their very nature entrepreneurs do not want to remain small. If your goal is to remain small, then good luck finding investors. The entrepreneur says, “well by small I mean that I’ll be small for the next year or so, by then Bigco will forget about me.” Again, the problem is that if you are an entrepreneur you do not want anybody to forget about you. You are going to announce to the world in print, email, websites, etc. how you have the perfect solution or the next killer app. And, when you do that, Bigco will find out about you and remember you.

Another problem with the “being small” defense is that your investors will not be as small as you. If you eventually look for institutional money from an angel group or a venture fund, they will not be “small.” They will not want the potential liability of Bigco coming after them. As an extreme example, two record labels sued Napster’s venture capital investors recently¹. That lawsuit involves indirect IP (read music) theft. Although it is not a claim based on IP developed during employment, nonetheless, it does show how far some companies will go to protect their IP and to seek restitution.

I do similar work for Bigco, but they don’t want to pursue this

In this case our entrepreneur still works at Bigco, had a cool idea there and wants to pursue it outside of Bigco because Bigco has shown little or no interest in it. That is great if Bigco agrees. There are many reasons why they might agree. Perhaps the idea might be for a product in a market worth tens of millions of dollars, but Bigco is only interested in pursuing new ideas that are useful in much larger markets. Maybe they have divested the division that originally sponsored the work. Again, in these cases an agreement needs to be worked out between the entrepreneur and Bigco.

Often, entrepreneurs in this situation say that they have not gotten such an agreement with Bigco. What that means is that they are using Bigco resources (i.e., their time, their colleagues times, Bigco equipment usage, etc.) to start their own company and without Bigco’s knowledge. This is a dangerous situation.

Trademarks

A trademark protects a logo, a product name and potentially some of the marketable aspects of a product, but not those of a functional nature. It is mentioned here for completeness, but it is usually not an IP issue between entrepreneurs and their former employers.

¹ Olsen, Stefanie, CNET News, “Record labels sue Napster investor”, <http://news.com.com/2100-1027-997860.html> (April 22, 2003)



“They expect that when they leave Bigco it will just abandon the work and move on to other ideas. This, of course, is pathologically wishful thinking.”

Because this activity is a “current” activity at Bigco, there is no telling where this might lead. It could result in an agreement to let the employee start the new company with Bigco’s blessing or it could result in his immediate dismissal and a restraining order.

When the entrepreneur is smart enough to figure out the risks, they sometimes try to cover this up by saying that they are aware of the risks and are keeping their activities secret from Bigco. When the time is right, they will leave, launch the company, get investment funding and become big enough to fight Bigco and, of course according to them, Bigco will have lost interest in this area by then. Sometimes, they even claim that Bigco’s loss of interest is guaranteed because the entrepreneur is the only one at Bigco that understands the technology. They expect that when they leave Bigco it will just abandon the work and move on to other ideas. This, of course, is pathologically wishful thinking. Doing this work in secret will gain nothing except personal animosity in addition to legal action once Bigco’s management finds out what has happened.

The good news, as alluded to above, is that this is a good time to negotiate with Bigco. As an employee who has expertise in an area that Bigco is no longer interested in (well, at least you perceive that) and a plan for how to take it to market you will probably get a hearing with management. Since you are an insider, initial discussions will not have the bluster on Bigco’s side that might exist if they were talking to an outsider.

Sometimes this scenario unfolds, not because the entrepreneur is trying to be clever, but because they cannot decide whether or not to leave Bigco. They want an exit path or they think it would be exciting to actually leave and start a new company, but down deep inside they are not fully committed. That situation is understandable. However, before you can go from employee to entrepreneur you need to make that commitment. You will be wasting your time and the time of potential investors and customers if you started talking to them about some interesting IP to which you might not have rights.

Trade Secret

A trade secret is a difficult thing to manage. It could be your idea or the source code or research notes. But, no matter what it is, it must be kept secret. Period! In software a trade secret is difficult to protect. What you think may be your secret and clever trick that no one will ever find out could be simultaneously thought of by anyone anywhere on the globe and published on the Internet. The real power of the trade secret law is in protecting your working material from outright theft.

What To Do And Not To Do

Get an agreement while you are small

As mentioned several times above, you are in a much better position to negotiate with your employer while you are still employed there. If you are no longer employed, then you still have a better chance of negotiating with them while you are an individual and not perceived as a threat. If you are not taken seriously, make sure that you document your communication, as it might be useful at a later date if you come back with potential customers and investors to prove that you should be taken seriously.



Proprietary and Confidential Data and Non-disclosure Agreements

Trade secrets and documents that describe your ideas, your plans, and your procedures need to be protected, as well. Protection for these typically comes in the form of Non-Disclosure Agreements (NDAs) you execute with business partners so that no one walks off with information that can be used against you. NDAs are also often part of the employment agreements companies execute with their employees.

It's tempting to use NDAs all the time. Unfortunately, entrepreneurs must be as concerned about building relationships as they are with building technology. This means that you must take precautions other than NDAs when talking to potential investors and clients who might be reluctant to sign. Tracking numbered copies, giving each copy of information a unique characteristic (e.g., product code name) so it can be traced if leaked and limited disclosure are some approaches to the situation, but all risk disclosure to some degree.

“Do not make the mistake of thinking that you understand enough of the law to get by.”

License The Work

If you developed a patented idea or copyrighted work for your employer, see if you can get a license for it. A non-exclusive license will probably be the easiest to obtain, but may not give you or your investors enough protection. You might also be able to license the use of part of the patent or work if you do not need access to all of its claims.

Use The Power Of The Inventor/Author

It is likely that, as the inventor or author of the work in question, you are the acknowledged authority at your employer in the subject area. If that is the case, then you can use that to your advantage. The argument that you understand the technology best and, therefore, you should do what you want with it will not work. But, if negotiations get tough, you are probably the best one to know how to work around the patent or copyright in question. You can argue that you would rather work with your employer and give them a piece of the action, rather than spend (or waste) a few months of your time and develop a new and independent idea that cuts them out of the deal.

Be Creative About Licenses or Agreements

Your attorney will probably suggest that you do not become too creative about licensing or legal agreements. However, you do have options when it comes to negotiating a deal. You can propose that the license fees or royalties be paid at a variable rate. Perhaps the royalties decrease over time (a high initial royalty or license to satisfy your employer and a lower one later to satisfy your investors). If that does not work, you could propose that the fees be decreased as certain milestones are met. For example, you might pay 20% of sales until you have paid \$100,000 in fees (which might match the loaded cost of your time at your employer while you developed the idea) and then pay 5% on future sales.

You can also offer an equity stake in your new company to sweeten the deal. If you are very creative, you might say it is for a royalty credit. For instance, you could say that you will give them X% of ownership in your company and will pay 5% of sales as royalty/license fees, but that you will not start paying those royalties until you've made \$2 million in sales. Five percent of \$2M means that their X% ownership was for the waiving \$100,000 in fees owed to them. This, of course, puts a specific price on your stock, which has its own set of advantages and disadvantages, so please consult an attorney for specific legal advice.

Get Your Employer To Participate

Another advantage of getting your employer involved early is that you can try to get them to agree to purchase a certain amount of your product as part of a licensing deal. If they will not agree to that, you might try to get a letter of intent from them to purchase product. This commitment by them will be very useful in getting your first few sales and for getting investors interest.



Use The Right Of First Refusal

Your employer may not have many reservations about your ability to start a company, but they may have significant reservations about who might eventually own your company and the IP rights they are granting to you. If this is a concern, you should consider giving your employer the right of first refusal. Here the idea is that if they are concerned about your company being bought by the competition, they have the right to look at the deal first and accept it or refuse it. They should have to match the deal in all aspects. If you are trying to negotiate distribution rights on a patent or copyrighted work where you can sell licenses to others, a right of first refusal might help with such concerns. The idea would be that if you try to set up a distribution deal with a competitor of your employer, your employer could pick up that distribution deal instead. This, of course, severely weakens your business so you must be careful and seek additional advice before proceeding.

Do Not Pretend To Be A Lawyer

As stated numerous times above, seek council from an attorney before deciding upon a final course of action. Do not make the mistake of thinking that you understand enough of the law to get by. However, keep in mind that your attorney will be looking out for ways to protect you from legal action, but not all business issues are legal ones.

Summary

Intellectual Property ownership issues are critical for entrepreneurs. These issues need to be thought about before launching a company. Most entrepreneurs want to mitigate the risks of starting a company by testing the waters first. They try to see how far they can develop the technology or how interested customers are before they make their own commitments. However, before they know it, they have infringed on an employer's patents, stolen (in their employer's eyes) customers, or started a time clock on patent filing.

You have to think about the story you are going to tell your investors. Unless you have a lot of cash and can bootstrap your company into the Fortune 500, you will eventually have to seek outside investments. When you do, they will want to know what IP you have, who really owns it and how you are protecting it. You need to start thinking about how you are going to answer those questions before you start your company.

Do not assume your employer or former employer is dumb, uninterested, or does not sue. Companies always keep track of things that cost money, including the labor costs of a project, the patent attorney fees and patent office filing fees. This will ensure that they do not forget about the work that was done.

Take advantage of your size. Do not presume you will eventually be big enough and rich enough to fend off any claims. Settle those issues while you are not perceived as a big threat. If you

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think you will be laughed at, at least have the discussion and see if they will agree that if you address whatever skepticism they have they will reconsider.

Do not forget to protect your own IP. The stuff you came up with that is clearly yours. Protect it with patents, copyrights, trademarks, trade secret notices and sufficient security. Documenting these practices will enhance your story to investors.

One final note: do not forget the little guy. Remember what it was like and when you make it big and an employee of yours is interested in taking some dead-end technology and doing something with it, foster and promote their entrepreneurship.

About The Author

David Jakopac is Vice President of Lisle Technology Partners, LLC, a consultancy specializing in strategy and software services for advanced technology start-up companies. David was a founder of three start-up companies, one of which went public. At LisleTech, David is involved in strategic start-up development, software technology design and management, and venture capital due diligence. David had designed and managed the implementation of software technologies for start-up clients in the areas of XML translators, call record processing for Telco billing, business strategy execution tools, logistics systems interfaces, 3D web-based visualization of new home construction options, and on-line 3D racing and skateboarding games. Some of David's technology developments have resulted in patent applications. David has also performed technical due diligence for several private investors and venture capital firms on companies in the following markets: web-based stock purchasing and portfolio management, Enterprise Application Integration, and Business-to-Business Integration. David holds Ph.D. and M.S. degrees in Computer Science and Electrical Engineering from Northwestern University, and a B.S. in Computer Science from the University of Florida.

For more information about this topic, please contact:

Lisle Technology Partners, LLC
650 Warrenville Road
Lisle, IL 60532
Phone: 630-353-1900
FAX: 630-353-1930
Web: <http://www.lisletech.com>
Email: info@lisletech.com

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