From Doodle to Dollar

A Pathway to Profit for Your New Invention

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This book is for educational purposes and does not constitute legal advice.

About the Author

Mr. Tormey has over 30 years of experience in product development, marketing and intellectual property protection. As a company startup veteran, Mr. Tormey brings a unique perspective on the value of intellectual property to small and growing businesses. Besides counseling his clients, he has also delivered many lectures to entrepreneurs and business executives on how to form businesses, protect IP assets, and avoid litigation in the early years..

As a patent attorney, Mr. Tormey has drafted patent applications covering software, electronics, wireless, mobile applications, encryption and automation controls. His legal experience includes IP litigation, corporate formation, governance, dissolutions, and international transactions.

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In the Beginning

As a patent attorney I've seen hundreds of products or business ideas come across my desk. Often presented by people who have little or no experience starting a business. This book is directed to those people. In these pages each phase of commercializing a new idea will be explored, and, if I meet my goals, you the reader will have a better grasp of the process and real-world tools to help your product become a success.

This is not a law book, but it is a how-to-use-the-law book. It is also advice for properly getting your invention to market. Starting a business is one of the most challenging, difficult and rewarding things a person can do. For most entrepreneurs, all the effort has to go into making the product and making sales. Learning the law is the last thing they have time for. Besides, law is often a very boring collection of rules that only sorcerers understand. Entrepreneurs abhor rules.

This book is organized into three main sections. Part I is the basic homework to do before spending any money trying to commercialize your idea. Part II is a look at taking your idea out to the public to get some real feedback and how to protect your idea before you take it out. Finally, part III is building your business from the ground level. There are no hard and fast rules, but ideas and suggestions that can help make the process a worthwhile adventure.

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SECTION I

The Idea Stage

Products Versus Services

In this book the terms product and service will be casually applied because the concepts are similar for both. However, there are some differences between them – especially when it comes to marketing. In many areas products and services are becoming indistinguishable. Think of products that connect to the Internet. Often there is a service component to even the most basic product idea. For example, Ring makes an online doorbell. Of course, the follow-on service component might be the most profitable area to operate, so the concepts described here will cover both products and services.

Make, Market, or License?

The type of product and service you have determines your pathways to revenue. If you have a product or service that can be legally protected, with a patent for example, then you have the option to simply patent it and sell the patent. Hopefully to a company that will take it, finalize the development, and do all the sales and marketing. However, if you have a service business, it's harder to license because it's actually the service you're selling and not a product. The ability to license it becomes more limited and the licensing option might not work for you.

Licensing

Licensing generally means letting another sell your invention for a fee. If you have a product or service that you want to license, you're going to have to protect yourself with one of the legal means for protection. No one is going to pay your license fee if they can just go do it themselves. This means you have to copyright, trademark or patent. Later this book will cover each of those in detail, but if you hope to get your revenue by merely licensing it, you must take some steps to protect yourself before shopping around the license.

Build and Sell

If licensing doesn't work for you, then you're still in luck because there are a lot of tools available to help you get to market. It's never been easier to develop a manufacturing system or to partner with some manufacturing organization. You might also need a sales organization too. Today, with places like Amazon, once you get your product built you have an online sales channel. It's readily available by simply signing up an offering the product for sale. Amazon has tools available for its resellers that make each step of the process easy to figure out. Also, even though Amazon is a household name, there are other sites and other countries where you can sell your products such as Etsy, eBay, and the like.

The biggest problem is going to be determining how to get your product designed and built. if you're already an engineer or designer you're in pretty good shape because you can take the computer aided design (CAD) files to some manufacturing facility and they will make it for you. if you aren't that tech savvy or you're not an engineer designer, then you're going to need a design partner to succeed. There are many available. Often, they have a US presence and work together with an overseas manufacturer to get the product built. The details for this are covered in later chapters, but what you're looking for is a design that makes it affordable to manufacture. When you search online, the phrase they use is "designed for manufacturability". As well see later, design the cost out of your product, you'll be glad you did.

Whether your plan to sell a product or service, you should familiarize yourself with all the tools listed in this book because things change over time. What was traditionally a product that you would sell is now often connected to the Internet. Similarly, a service product might end up having a hardware piece to go with it. So before you begin down this path it's a good idea to take a short overview of what makes products and services successful. The easiest way to do that is to look at products and services on the market that are successful.

Successful Products and Services.

There's a real quick test to decide if your new product or service is going to be hit on the market -- ask yourself if it's faster better or cheaper. Being any one of these will help you succeed. If you can be 2 out of 3 you're in great shape. It's rare to find a product that does all 3. However, it's these 3 things that drive a product on the market. At the end of the day, when potential purchasers evaluate a product or service, in the back of their minds they're asking if this will save time, money or do a better job.

Faster and better go together because they both say similar things. I often ask my clients to tell me how, if you were selling this product, how would you pitch it? Then you see the value of asking yourself is it faster, better, or cheaper -- that's what you going to lead off with when you're trying to talk someone into buying your product or service. Customers don't buy features they buy benefits, so your product or service might have wonderful features but at the end of the day the customer buys the benefit they get. When Amazon first started their advertising, they promoted the "Earth's biggest Bookstore." It was an excellent slogan for several reason, but most importantly it told the world that they have the book. Yes, back in the day Amazon was only an online bookstore! They promoted the benefit that you can get any book because a big bookstore had it all. People purchased from them because they knew they could get it. That was the benefit people wanted. As a bonus you can order it online.

A good way to promote the benefit your product or service has is to show that your product or service solves a problem that people have. You'll often hear this described as a pain point, and if your product can solve that pain then you have a significant advantage. Faster and better are great benefits to deliver to a customer.

As for cheaper, there's always room at the bottom of the market. If you can bring something to market for less than everybody else, you have a chance at success because people normally are price conscious when they shop. However, before taking a product to market, ask yourself if you really want to be the low-price leader? If you're going to bring a product to market as the low-cost alternative, then you have to build low cost into all your business structure because whoever is already there is probably going to try to cut cost to catch up with you. Low cost is one of those sustainable competitive advantages that companies can get but they have to build it to their whole business infrastructure.

Market Fit

At first most people think they know exactly where their product will fit in the market, but they learn otherwise. Market fit takes some research to find out who has the money and who gets the most benefit. With any luck they are the same people. You don't want to be in a situation where you're trying to sell the most value to people with the least resources to pay for it. When you start to bring a product out, talking to a lot of customers is the key to finding out who has the resources to pay for your product or service and who is getting the real benefit.

One thing to watch out for is the problem of having to create both sides of a market. Consider an auction site like eBay. To come online they needed two things -- buyers and sellers. So when they were initially promoting their product they had to get both sides to come on board for it to work. Fortunately for them people are familiar with the auctions and know how they operate. For more complex products and services, it is significantly more difficult to get started because you have to promote to both sellers and purchasers.

You as Entrepreneur

You and Your Idea

There is one main characteristic that all successful inventors have and that is that they want to see their new product or service on the market and available to everyone. They believe in their idea and want it to become reality. This drive to get the product to market is stronger even than the drive to make a profit. I see this drive within the first few minutes of talking with them. They are convinced that once their product is available it will make their customer's lives a lot better. They are passionate and obsess over their idea. If you are serious about making a successful product, find that passion and let it drive you to success.

Enthusiasm is infectious. Showing your enthusiasm will help you find the resources to succeed. People want to back a winner, or in some cases, help an underdog. So, find the time to talk to as many people about your business proposal as you can. But before you do, read on to see how to protect yourself.

Domain experience

One of the most critical things to have for your product or service is domain experience. That means that you know the industry. Hopefully, your new idea is from that area – an area where you have a lot of experience. If you don't have it, you're going to need to get some help. Often the best way to do that is to hire somebody with the domain experience you need. If you can't hire, then you're going to spend a lot of time talking to people in that industry. You need to find out from them what they've learned from their years in the industry. What's worse is they might not even be aware that they have that kind of knowledge and you're not even sure what you're looking for. This takes some work but if you don't do it, you're almost guaranteed to struggle until you do know it. Or fail.

Your Baby is Ugly

Often our clients have what seem to be good ideas, but they don't want to do the initial research to find out if their idea is marketable. I realized, after doing it myself, and watching a few others do it, that they're afraid to find that their product or service doesn't really have a place in the market. Nobody wants to hear that their baby is ugly and they're afraid that if they ask a lot of people about their product or service, they're going to find out that their product has no market – they have an ugly baby. Yet they're personally invested in it because they think it's the greatest idea since sliced bread. However, the time to find out your baby is ugly is before you invest your life savings getting a product or service to market.

Don't invest in an assumption. It's tragic to see someone who's invested a considerable sum of money only to find out the hard way what they could have known before -- their product wasn't going to sell. Maybe they were targeting the wrong people or maybe they developed the wrong product, in any event, had they done the up-front work before they spent a lot of money, they would've been much better off. The up-front work is talking with lots of potential customers early.

Three things can happen when you introduce a product to market. It either sells well, doesn't sell at all, or limps along with slow sales. The best of course is that it sells well. The worst is that it simply limps along draining the life out of you and your wallet. If your product dies quickly, it is your opportunity to quickly move on to the next great idea.

Get customer feedback constantly. Don't be afraid to listen to what people are trying to tell you. The users will tell you what they want.

Customer Research Warning

"There is a problem trying to figure out what people want by canvassing them," wrote cruise ship designer John McNeece. "I mean, if Henry Ford canvassed people on whether or not he should build a motor car, they'd probably tell him what they really wanted was a faster horse."

Before You Begin – Research!

All too often, I find that a great idea has already been done. Sometimes it is already for sale! So, before you begin, do some deep research. Initially, you're looking for two things. First, is it on the market? Second, is the invention already known? Just because a product is not on the market doesn't mean it hasn't been done before. Maybe it already flopped on the market, and the company making it threw in the towel. Either way, you want to do the basic research to know what is going on. The steps in this section will get you started.

For Sale?

Try to buy your new product or service. Finding it online might not be straight forward because the industry may know it under a different name. If it is a consumer product, your search will be easier. They will be selling everywhere. If it is a business-to-business product, then you will need more research because it might be buried deep in a catalog or included with another product. Don't be afraid to pick up the phone and ask a supplier if they have the product. If they have it your job is done, and you can move on to another product idea. If not, whoever answers the phone might give you a wealth of information. For example, they can confirm the problem needs a solution. Or maybe tell you of similar products or solutions that people are already using. People in the industry have domain experience and usually will be happy to share it with you. Remember that simply asking if they have a product does not mean you need to give them the details of your invention. Keep the "Secret Sauce Recipe" to yourself.

Because industry insiders have domain knowledge you should take advantage of it as much as they will let you. For example, describe the problem your product or service solves and ask them if they know a solution. Then listen carefully. As you talk with more people in the industry you will learn how they think about the problems and often either talk you out of wasting your resources on a product that will fail or give you great ideas to make a hit product.

It's hard to know how many people in the industry you should talk to but try for at least 10 people. Of those 10, hopefully one of them will spend some quality time with you and confirm your intuition about the need for your product or service. Remember, don't try to sell them your product or even tell them you have a solution. You are in listening mode.

Already know the Industry?

If your new product is for an industry you are already familiar with, you have a head start. However, it's still beneficial to get another opinion. It you have a few trusted friends in the industry, bounce the idea off of them.

Where you fit in – the product matrix

Once you've done your initial marketing research, you're in a position to create what's called a product matrix. A product matrix is simply a comparison between your proposed product and all the solutions that are already out there on the market. Down the left-hand side you put all the features and benefits that you think are critical to your prospective customers. Across the top in the first column put your proposed product. Next to your products you put all the competing products that are out there. On the bottom row put the prices. Here's an example:

Feature	**You**	**Competitor A**	**Competitor B**	**Competitor C**
Rechargeble	Yes	Yes	Yes	No
Long Battery Life	Yes	Yes	No	Yes
Lighted	Yes	Yes	Yes	Yes
Easy to Use	Yes	Yes	No	No
Same-Day Delivery	No	Yes	Yes	Soon
Mobile App	No	No	Yes	Yes
Retail Price	???	$99	$129	$67

A product matrix helps you visualize where your product is in the real world. This is the formal way to look at products from the point-of-view of an informed consumer. It is also a great tool for showing potential investors what you bring to market that is faster, better, or less expensive.

A well-designed product matrix will show enough detail that the value of the features will become evident. For example, if all the wireless versions sell for $50 more than the wired ones, you can put a price to the wireless feature of $50. It's also smart to add some forward-looking radar to your matrix. What features are the competition working on that you can reasonably expect to hit the market in the next 6 months? Put them in there too because you need your product to be fresh.

No Competition?

A product matrix only works if you can provide details about the competition. You might be in a situation where you have no competition. If so, there is probably something wrong. If there is nobody offering the product you propose, then there might not be a market for your product. One nice thing about competition is that it proves there is a market for your product. The big tech companies all had some form of competition when they started, Google had Yahoo, Facebook had Myspace, and Microsoft had Apple. Don't be afraid of a competitive market, but make sure you offer a product that is faster, better or cheaper, so you can be competitive too. It is rare to see a market so open there is no competition, but often there are small market niches with little competition.

Do the Math

It's hard to know exactly what the cost of your product or service will be until you start operating. However, with a product matrix, you can work backwards to determine the limits of your cost. For a traditional product the cost of goods should be less than 30% of the retail price. This leaves room for all the other players in the product distribution channel. For example, distributors conventionally want about 30% markup.

The real cost of your product must include all the associated costs, like packaging, taxes, labor, and distribution. This is referred to as the “fully burdened” cost of goods (COG). It might be cheap to manufacture in China, but if shipping it to your market drives up the cost too much, you are out of luck. Ultimately, you always strive to keep your costs as low as possible, but when you introduce a new product, it helps to have a target cost you must beat. If you can’t beat the costs, then maybe you should be spending your time on another one of your great ideas.

Sustainable Competitive Advantage

Once you have a first guess at where you will be in the market and what your costs need to be, you are in a position to start structuring your business. To make it for the long haul, you will need to build into your business sustainable competitive advantages (SCAs). These are the strong points you have that give you the edge over your competition. These include working capital (cash), a good network of resources, an efficient operation, intellectual property, and specific areas of expertise (know-how).

There are some areas where you will never have a sustainable competitive advantage and there is not much you can do about it. Your competitors exist for a reason, and that means they some type of competitive advantage over you. However, in those areas where you can dominate, a sustainable competitive advantage should play a part in every decision you make. If you do not have a sustainable competitive advantage, better rethink what you are doing because it won’t survive any competition.

SECTION II

Getting Out There

Once you've done your preliminary research, you are ready to face the wide world. This involves getting more accurate market and cost information. Hopefully, the market price will be significantly greater than your per unit cost. Even if you hope to only license your idea, it still helps to have a clue about whether your technology has value in the market. The risk you take at this point is that someone will steal your idea.

Taking a new product to market takes a lot of time and money, whereas good ideas are cheap. Creative people usually have significantly more product ideas than the resources to bring them to market. This is why theft of product ideas is relatively rare – at least for smaller startups. Getting the product to market is the hard part – not thinking up a good idea. However, the amount of legal protection you need will depend on what business you are trying to commercialize.

Whose Idea is it?

Don't lose ownership of your idea. As you explain your idea to others, those people start to contribute to your idea. It is possible for them to contribute enough that they believe they are co-founders with you. While cases of accidental co-founders are not common, they are common enough to warrant a brief discussion. Legally, the person who thinks up the idea and reduces it to practice is the inventor. It is also possible for a group of people to work collectively to come up with the idea.

Historically to reduce an invention to practice meant making a protype, but modernly, if you can generate a set of instructions on how to make the invention, then you do not need a working prototype. It follows then that you can hire someone to make the instructions for your invention and not have to build it yourself. For example, if you need a circuit designed or software written you can hire someone to help implement your invention and still keep inventorship for yourself. Like all legal strategies in this book, you should check with an attorney about your case.

When you enthusiastically tell your friends of your idea, be clear that they are not part of your team unless of course, you want them on your team, especially if you think your idea is patentable. There is no magic formula for this, just avoid saying things that make them believe you are inviting them to join you in this adventure.

People often ask if they should have a confidentiality agreement with the people they speak with. Confidentiality agreements, often called non-disclosure agreements, are contracts where a person agrees not to tell your secrets. The answer is, it depends. In the very beginning you are likely to speak to trusted friends only. Invention theft on this level is fairly rare, but not unheard of. If you don't trust them, don't share your idea with them. Once you branch out beyond your trusted friends, non-disclosure agreements are common with professionals and most engineers and designers will sign one without much objection. See *Non-Disclosure Agreements* below.

One hard truth about entrepreneurship is that the money goes to the person who executes, not the person who merely has the idea. Ideas are cheap. Most creative people have plenty of them. It is in pushing the idea to market where all the work and risk is. With that work comes the rewards. Most people are not willing to do the work or take the risk. That is why invention theft is rare in the early stages. As you will see, a new idea is an invitation to lots of hard work.

Where entrepreneurs get into trouble is when they are not clear that it is their idea. It's easy to do because you are excited about it and want to get approval from others. Your friends naturally start making suggestions and before long they start acting like owners or partners. It is important to get feedback. The more feedback you get, the better your chances of success because. Just be clear in your early conversations that you are not inviting them to join you.

Non-Disclosure Agreements

A non-disclosure agreement might help. Sometimes called a confidentiality agreement or secrecy agreement, a non-disclosure agreement (NDA), is a legal contract between the parties that describes the confidential information that the parties want to share with each other, as well as their agreement not to disclose that confidential information. There are pluses and minuses to an NDA, but before we go into those, be sure your agreement is a valid one.

NDA's must clearly spell out who the parties are and describe what is confidential. Many startups simply download a generic NDA and fill in the most basic information. It is essential that there be enough information in the agreement for people to know exactly what the agreement covers. Many commercially available and well-written NDAs require that confidential information be marked "confidential" to be covered in the agreement. The problem is that startups usually discuss their ideas orally and nothing is set in writing that can be marked confidential.

If you use a downloaded NDA, be sure to describe your idea with enough detail to protect you. "My idea for a flying car" is not sufficient. However, "My idea for using duct tape and tooth picks to make a car fly" gives the court something to work with when it has to decipher what is confidential.

There are some downsides to NDAs. The most obvious is that people feel it is the wrong way to start a business relationship. It says, "I don't trust you." in a way that mere words cannot express. Also litigating a violation of an NDA can be expensive. Well-written NDAs have a clause that awards legal fees to the winner, but it can be time consuming and expensive, nonetheless. Another drawback is that people are not always certain about what exactly is confidential. For example, your idea for a car that flies using duct tape and toothpicks may be included, but is your financial or marketing information also included?

The advantage to an NDA is that it operates to minimize disclosure of your confidential information. Smart business people want to avoid lawsuits, so they will tend to honor their NDAs. Also, reputable firms honor privacy agreements even if they aren't written down – simply because they are reputable firms.

Many professionals simply won't sign an NDA. For example, investment groups see many business plans and do not want to make themselves sue-able by signing an NDA. That's reasonable. But it's a mistake to think a potential investor will maintain your secret as a matter of honor. Venture funds tend to invest in a small market space. Before you hand over your secret sauce, do your research; make sure that investor is not already invested in your competition. After all, they don't know what you are about to tell them. If they are already invested, or about to invest, in a competing firm, you'll only burn yourself by spilling your secret sauce. If there's a potential for conflict, find another investor.

Once you get past the NDA stage of only disclosing your idea to trusted advisors, it's time to look into more formal protections.

IP - The Basics

Before getting out there, you may need to take some steps to protect your ideas. Fortunately, intellectual property (IP) laws work to protect you if you use them properly. This section describes the forms of IP and suggests how you can take advantage of them.

The problem is that entrepreneurs need the benefits of the law, especially intellectual property (IP) law. This book is designed to get the legal concepts into your brain without smothering you with rules, so you can apply the concepts to your startup. Looking at intellectual property law as another business tool helps you use the law to maximize your success in business. Thus, the goal of this book is to get you to think about intellectual property in a way that makes good business sense for your business.

Intellectual property is best viewed as a way to achieve a sustainable competitive advantage for your company. Sustainable means over the long term; Competitive means giving you the opportunity to make money in your industry; Advantage is something your product or service has that no other firm has. Intellectual property is one of the ways to acquire sustainable competitive advantages for your startup. Fundamentally, all intellectual properties provide you with a sustainable competitive advantage over your competition. Before you can acquire intellectual property however, you must first be introduced to the different types of intellectual property.

This chapter covers the basic concepts around intellectual property as property. Just like real estate, intellectual property needs to be clearly defined, and its ownership firmly established. It’s hard to do that on a cocktail napkin – particularly if the cocktail it once hosted has already firmly established itself in some of your intellectual real estate.

Trade Secrets

Know how to keep a secret? Coca-Cola does. Their recipe is one of the most successful trade secrets in history. Other famous secrets include the recipes for Kentucky Fried Chicken and Famous Amos Cookies.

A trade secret (a.k.a. “confidential information” or “classified information”) is some formula, practice, design, instrument, or compilation of information not generally known or easy to obtain, that gives a company a sustainable competitive advantage.

In the case of a trade secret, if you know how to do something that nobody else knows how to do, you have a very serious advantage. And that's a good thing, assuming of course that your product is something the public actually wants to buy.

Your secret could be something as simple as your sales strategy or customer list. If you have an innovative way to sell your product that could beat the competition, you probably want to keep that a secret. It may turn out that, like Coca-Cola, your trade secret is one of the greatest assets your company has.

Of course, not everything your business does constitutes a valuable trade secret. If it's generally known or easy to obtain, it's not a secret. If everybody in your company already knows about it, it's not a secret. And if it doesn't really provide you with a competitive advantage, it might be a secret, but it doesn't qualify as a trade secret.

How Trade Secret Law Works

Let's put the idea of a trade secret into a business environment and take a look at it.

Say you manufacture widgets and your widgets cost $1.50 a piece, about the same as your competition. One day, you discover a "secret" new way to improve your process that saves you 25¢ per widget. Now you can either (a) keep your price the same as your competition and make more money for each widget that you sell; (b) sell your widgets at a lower price and make more money by selling more widgets (presumably to your competitors' former customers); or (c) try a little bit of both. Whatever strategy, you have a serious market advantage and you're going to make more money.

What the law allows you to do is to establish that you have a trade secret and to protect that secret by keeping your employees, vendors and competitors from discovering and/or stealing it. Then, under trade secret law, you can force any competitor who poaches the secret to stop using it.

For instance, say you have an employee who knows the secret to how you save 25¢ a widget, and your competition offers him a job. If you have done due diligence in establishing and protecting your trade secret (see below), you can stop that employee from telling the competition what the secret is, and if they do use it, you can stop that competitor from using that secret in their business.

How to Establish a Trade Secret

Fortunately, trade secret protection is very broad and pretty affordable. You don't even have to file any forms with the government, but you must take steps to protect your secret from accidental or intentional discovery. Be sure that company secrets are clearly marked confidential and the people who have access to them know they are secrets. Beyond that, you also need to establish appropriate security procedures—passwords, locked file cabinets, discussing secrets in secure settings, etc. By doing so, you can demonstrate that you overtly and proactively guarded your trade secret. Later on, if you end up in court, you'll be glad you made the effort.

Your Most Basic Line of Defense

Trade Secrets are a natural focus for start-up companies. Many are trying to do something new; something other people haven't figured out. It's your "secret sauce." Playing things "close to the vest" is just plain smart. As a business person, you want to be able to look around your business and determine what can be protected as a trade secret, what should be protected, and what can't be protected because it doesn't meet the criteria.

The Big Idea, even if it's a little thing, is usually worth protecting. As a start-up, keeping your trade secrets secret is your most basic line of defense. It's simple to do, virtually free, and an effective way to give yourself a sustainable competitive advantage.

Trademarks

Fundamentally, a trademark indicates to the buying public who is the source of the product or service. When you deal with the Trademark

Office, that's the test they're going to use in evaluating your trademark. The question is, does the general public associate this trademark with your company?

Your trademark can be the name of your company, but it can also be your logo, or both. While it specifies you as the maker of the product, over time it starts to embody something else—your brand.

Your brand is your reputation. It helps to distinguish you in the marketplace; influences buying decisions; and makes it increasingly easier for you to remain profitable. So the real value of a trademark is the brand identity that it embodies. It's the difference between Joe DiMaggio and Joe Six-Pack.

Origins of Trademark Law

Trademark law dates back to English Common Law[1]. A superior tradesman, a swordsmith, indicated by a mark on his sword that he was the one who made it. Some lesser swordsmith thought, "Forsooth! If I put his mark on my inferior swords, I can sell them for a lot more money!" This he did, and benighted knights strapped for cash bought inferior quality swords "on sale" thinking they were superior quality swords. After taking a royal beating in the next battle, the king, seeing all his dead knights and broken swords, summoned the superior swordsmith and was about to decapitate him when the swordsmith spoke up.

"If you're going to chop off my head, at least use one of my superior quality swords," he said.

"But this *is* your sword," the king replied. "Here's your mark right on it!"

"I didn't make that piece of crap, you twit! It's a forgery! What this kingdom needs is some serious intellectual property laws."

Being wise, the king agreed. The superior swordsmith was spared, and laws were passed to regulate how craftsman can mark their products.

[1] Research indicates that the following account probably isn't true.

England started winning more battles and went on to become a leader of the Free World. History doesn't say what happened to the inferior swordsmith, but we can surmise it wasn't pretty.

As you can see, trademarks are an early form of consumer protection and a way for you to build your brand equity.

Trademark and Brand

The words trademark and brand[2] are often used interchangeably, but the difference is worth noting.

A trademark is simply a word or graphical image (logo) that people associate with a company. But a brand is much more general and harder to delineate. It is the sum total of all the connotations triggered by the trademark word or logo. The brand is the persona of a company, based on the cumulative impressions the marketplace receives over time. This includes news reporting, advertising, public relations, word-of-mouth, direct experience with the company and its products and much more. Like a person's personality, a brand can be likeable, disagreeable, strong, weak, reliable, undependable, positive, negative, virtually anything. Moreover, these impressions can differ from one market segment to another.

Even No Brand Is Still a Brand

Like it or not, every company has a brand. Even if you leave no impression at all on the public, that says something about the kind of company you are. The classic public relations pitch usually includes something to the effect that, "If you don't manage how your company is perceived by the marketplace, your competitors will." That's why most companies take steps to ensure that they leave a positive impression on the public.

But the idea of branding extends far beyond marketing. Consider what the words *Made in America* mean to people around the world,

[2] One obscure ancient definition of the word brand is sword, hence the term "brandish."

or *German engineering, Swiss-made, Republican, Democrat.* Donald Trump can be thought of as a brand. So can Las Vegas, London and Dubai. They all summon up impressions that go beyond the dictionary denotation or travel guide descriptions. But, of course, that's for another book.

Nike and the Meaning and Value of Brand Equity
Consider one of the most popular and widely respected brands out there – Nike, sellers of athletic shoes and sundry sporting equipment. But are those really all that Nike sells?

Some time ago Nike ran a bold ad campaign – billboards showing nothing but their swoosh logo – a checkmark on steroids.

Of course everyone recognized it. That trademarked logo has high recognition value and a lot of prestige, which is what's known in the ad biz as brand equity. People associate the "swoosh" with (a) quality; (b) the cool, hip persona which Nike has spent billions and billions of dollars cultivating; and ultimately (c) athletic glory. Any businessperson would kill for that kind of brand equity.

Stolen Equity: The Need to Protect Your Trademark and Brand
Put the Nike swoosh on anything and you immediately increase its perceived value to the public. The perception of quality increases, even if the quality itself remains the same.

I could put the Nike swoosh on my law firm's website, and people would somehow associate me with the Nike brand. Perhaps they'd think my law firm was a division of Nike. Or that we were their official patent attorneys. Immediately my prestige and marketability would go up. And just as immediately I'd find myself in court, because I would have stolen some of Nike's brand equity and "goodwill."

That's why we have trademark laws. Poaching a brand's equity by giving the impression that Nike was in any way involved with the delivery of our service, or that we had any kind of working relationship when none exists, unfairly turns the brand owner's considerable marketing and PR investment to your own advantage. Some companies will not even approve the listing of their names on actual vendors' websites as customers because of the implied endorsement of their product or service.

In the early stage of your company's development, infringement on your trademark and brand is not likely to be a concern. Hopefully sometime soon, you will have built a brand that others would love to be associated with, even if they aren't. Your trademark, and its associated brand identity, may well be your most valuable piece of intellectual property, perhaps even your company's greatest asset.

Making Great Trademarks

Since your trademark identifies your company, you want it to be unique. A completely made-up trademark is the strongest – very likely to be unique, attributed solely to you, your company and products – and grantable because no other mark or similar trademark exists. A good example is Kodak or Zerox. Both made-up words with no similar sounding trademarks. George Eastman, the founder of Kodak, explained: "I devised the name myself. The letter 'K' had been a favorite with me -- it seems a strong, incisive sort of letter. It became a question of trying out a great number of combinations of letters that made words starting and ending with 'K.' The word 'Kodak' is the result."

Next in line are suggestive marks that hint at the benefits without explicit meaning. Good examples are Fridigaire and SubZero, now readily known as the top refrigerator brands. Consider making up marks that are fictional but suggestive. For another example; Expedia and Travelocity. Both are fictional, the latter perhaps better in terms of suggestiveness in connection with travel, although expedition is just another name for the same. Both, however, quickly became identified with their services within months of being rolled out.

So, having a unique mark that no one else has is the goal. Completely made-up marks are the best. One approach is to consider an advantage or benefit of the product or service, and then make a list of those benefits. You can expand the list with a dictionary or thesaurus to find alternative words and phrases. Consider foreign word and phrases as well. One can then artfully combine fragments or words in a unique way or different order. Play around with the words a little. Maybe add a glass of wine (or two!). You might come up with a refrigerator that replaces an ice box by blowing cold air (frigid air) and get “Frigidaire” with an added e for good measure.

Another approach is a suggestive mark, such as Amazon, the longest river in the world was used to promote the idea of the largest bookstore in the world – endless flowing water and endless flowing books. Their logo also features an arrow connecting the ‘a’ and ‘z’ suggestive of offering everything from A to Z.

Running top candidates through some consumer screening is a great next step – how is someone from the general public likely to react and associate the mark. Ask them “What does this trademark say to you?” Trust your clients, customers and consultants for feedback.

So be bold, break out of the mindset to have your goods or service’s mark be too literal or instantly associated with your offering. Instead, trust that if you offer a great product or service that recognition will surely grow. When it does, your mark will be novel and provide a sustainable competitive advantage.

Example: IBM

Back in The Day when proprietary mainframes were king, people didn’t buy computers; companies did. The IBM brand had a strong quality image, one that extended well beyond its actual market, and into the general public. Even those who knew nothing about computers felt good about buying IBM. It was the safe choice. Everyone knew that “Nobody ever got fired for buying IBM.” This paid off big time after Apple created the home computer market and IBM introduced their cleverly named Personal Computer.

Build a Great Brand, Not Just Great Products

When you're running a small business, you want to focus your efforts on building a great brand, not just great products. Markets change. Products and service come and go. Your company will need to change with the times. Odds are, you won't be making or selling the same things five or ten years from now. But if the products and services you provide today are of reliably high quality, you'll be able to build a good brand that will embody all your hard work and the positive impression it generated and carry that brand equity forward, like a pedigree, to enhance the perception of each new generation of products.

Spend some time pondering your trademarks. Think about how you will use them to mark your products and how they will work in your advertising. If you need to, hire a firm to help you develop good trademarks. They are worth it.

> ***Example: BMW***
>
> Imagine the crosshair circle logo of BMW on a car. Even if you've never driven a BMW, when you see that logo you sense that you're looking at a superior example of German engineering. You might also think that people who drive one are good at their jobs because they're well paid. You might also think that BMW drivers are smug and arrogant. In fact, BMW once initiated a PR campaign to "correct" that perception in the USA; apparently some of BMW's customers developed superiority complexes of their own!

Mark Your Territory, ASAP!

When clients come to my office looking to start a business, I advise that they consider the protection of a trademark first. It's relatively easy to do; you can apply for a trademark even before your company has released a product, or before it even started using the trademark.

You can actually file an "intent-to-use" application for a trademark for something you plan to use but might not.

A proper trademark is not the name of the product or service, but the words or symbols that indicate the source of the product or service. This means that a proper trademark is used as an adjective, not as a noun. If "Cool" is your trademark, then "Cool widget" tells the public that these widgets are made by "Cool." Cool describes the widget.

When you first use your trademark, indicate you are using it as a trademark by placing the small "TM" mark next to it. Like this: Cool™ widget. Trademark rights go to the first to use the trademark in commerce, so record the date of first use, and keep a copy of your first promotional materials. If your business is online, save a copy of the web page and make sure it has ordering or contact information for your company, so the Trademark Office will know who is using the trademark and when you used it. Better yet, file to register the trademark.

If you have a good idea for a company name or trademark, <u>get the Internet domain for it right away</u>. Because as soon as you search for that domain, some bottom-feeder will see that you expressed interest in it, and buy it before you do. So when you come back later looking for it, you'll be forced to pay an outrageous price to the crook for the snazzy company domain name YOU thought of! So please: develop your company name, and trademark discreetly at first. Don't go public until you secure the domain. And if you find the domain name available, buy it on the spot.

As a business person, you probably realize by now that your brand is going to be very important to you, as important as the company itself. So don't just take it for granted. Take the steps you need to protect your brand, trademark, and logo. Because what you're really protecting is your reputation, and that is the future of your company.

Example: Intel

When PCs and notebook computers hit the consumer market, people knew very little about what made one better than the other. Intel's customers were the PC manufacturers; their customers were the consumers. Perhaps inspired by IBM's overflowing reputation, Intel launched the "Intel Inside" campaign aimed at their own customers' customers. People came in looking for the "Intel Inside" decal, which made it much easier for Intel's customers to sell their products, and buy more microchips.

Copyright

Copyright is another form of intellectual property. Copyright law gives the owner of the copyright the exclusive right to authorize others to reproduce the work, make derivative works, distribute or sell copies and display the work in public.

Most people think of copyright in terms of written words, but the law also includes literary, dramatic, musical, artistic, and other intellectual works such as poetry, novels, movies, songs, computer software, and architecture. Even street graffiti has been found to actually have copyright protection. However, copyright does not protect facts, ideas, systems, or methods of operation, although it may protect the way these things are expressed.

For a work to be protected by copyright, it must be original. The work must have been developed independently by its author, and there must be some creativity involved. Merely collecting information and putting it on paper is not sufficient. But it's different if the author used personal taste in selecting the information, then he has created an original work.

Authorship Establishes Copyright, Prima Facie

Copyright is free and automatic. It attaches the moment the artist or the author actually sets the material down in a tangible medium the first time. A copyright notice, or mark, is not actually necessary because the copyright already belongs to the author by virtue of their authorship[3]. And it doesn't matter whether the work has been published or not. However, if your copyright is violated or challenged, you will need to be able to prove who created what and when.

It may happen, although it is rare, that two authors independently create the same work. For example, if two individuals both create a story that by pure coincidence is nearly identical, but each without knowledge of the other, there is no infringement since there is no copying. In such a case, they both hold the copyright on their respective works. However, if one of the authors had access to the other's work beforehand, that might be enough to establish copying. This is a lesson George Harrison learned the hard way when *My Sweet Lord* was accused of infringing the Chiffon's *He's So fine* and the court ruled that because George Harrison had heard *He's So Fine*, it was plagiarism based on subconscious copying!

Registration Secures Legal Standing

If your "work of authorship" is vital to your business, or you suspect it will be popular enough that others will be tempted to duplicate it, you will want to take the legal step of registering it with the Copyright office. This simple and inexpensive procedure establishes just what you created and when. It greatly improves your legal standing and ability to recover damages in the event somebody infringes on your copyright. Registration doesn't prove you were the first author, but it does show a date when you actually had the copyrighted work.

Business Issues for Copyright

As a business person in a manufacturing, technology, or software company, you need to know a bit about copyright to avoid lawsuits

[3] But keep reading, you'll see why a copyright notice is a good idea.

and disgruntled employees. The key concept to understand is that there's more to copyright than just having your employee's work in your possession. You need to have *the rights that go with it – the rights to copy and distribute.*

Every day you and your coworkers will generate works of authorship. For example; these might include advertising copy, graphics describing your product, or web content. Generally, the copyright to these works belong to your company under the "work-for-hire" concept, but it's important to make sure people know this. So you will need a well-written employment agreement, especially for contract employees. This agreement should assign to you the rights you expect. If your business doesn't secure all the rights, you should at least be clear on what rights you do have. Copyrights include the right to exclusive publication, production, sale, or distribution of a literary, musical, dramatic, or artistic work. Your agreement should spell out those rights.

Get Your Rights and Protect Them

As a small business owner, you have two key concerns. First, even if you pay an author to create an original work, *make sure you have all the copyright permissions you need for the material you use*. Second, if you use other's content, even if you download it for free, then *make sure that you have permissions* to use the work.

An Illustration

I had one case in which a person had created a poster for their boss. After they had left the company, somebody (probably inside the company) thought the poster was cool and started reprinting it and selling it. The question was who actually owned the design of the poster? Moreover, who owned the rights to use the design for purposes other than those for which it was originally created? And what about the moral right of attribution—the right of artists to be associated with their work?

We'll cover this later under the concept of "work for hire." But it's important to realize that having an actual piece of art or writing in your possession is one thing; having the right to copy, reproduce, or sell, it is something else entirely, hence the name "copy" right.

Watch Out for Infringement

The Internet breeds copyright infringement. It's tempting to simply grab a picture or a few paragraphs from another web site and use them for your own. Resist the temptation. Copyright owners use online search tools to search for copyrighted works and go after the infringer, and sooner or later, they will find you. There are plenty of stock photography sites that sell affordable images you can use, so why not pay a few bucks and use a legal copy? Also, for small bits of published writings, try asking the author! Often, if you are only using a small portion of the writing, they will give you permission. Require that your employees and contract employees follow the copyright rules, because your business is responsible for any misdeeds by employees. If you pay to have a web site developed, make sure they own the rights to the images they use.

No section on copyright would be complete without mentioning software. Software is almost always copyrighted and you need to comply with the software license that came with the software. The good news for software users is that there are excellent free (or nearly free) programs and apps available online.

Fair Use

Copyright law allows for limited use of copyrighted information under a policy called "fair use." Fair use lets you use small amounts of copyrighted material for commentary, search engines, criticism, parody, news reporting, research, teaching, library archiving and scholarship. There aren't any clear boundaries for fair use, so if you're in doubt, check with your attorney.

Patents

A patent is an exclusive right, granted to an inventor to exclude another from making, using or importing an invention. Patenting can be a time-consuming and expensive process, but at the end of the process, patents can be very valuable because only the patent owner (or licensee) can make, use or import the invention into the US market.

The Patent Deal

When you really look at a patent, you'll see that it doesn't just bring value to your company; it brings value to society as a whole. The government is offering you its protection as part of a deal. The government is basically saying: If you tell us how to make this product, we will give you the protection of a limited monopoly, so you can benefit financially from your knowledge without direct competition. But that protection will eventually expire, and when it does, you agree that anyone who wants to can also benefit financially (and otherwise) from your knowledge.

People often consider patents as a tool to protect inventors, but as we'll see, they are better considered as a tool to protect investors. Considering the new medications, technologies, and inventions that permeate our lives, it's abundantly clear that society is the ultimate winner in this bargain.

Just Say "No."

Patents are a bit strange because they're a monopoly, a government-issued monopoly, and a "negative monopoly" in the sense that *they don't give you the right to make a particular product.* They give you the right to *exclude others* from making a particular product, or from importing it into the United States.

Take a Seat

Here's how patents work. Let's say you have a brilliant idea: a device that lets you sit up off the ground (in other words – a chair). You design a seat and four legs and apply for a patent on it. When that patent is granted, you will have the right to stop anyone else from making a seat with four legs. But note: not every chair is covered by your patent – only a seat with four legs is covered. Bean-bag chairs and upside down milk crates are not included. If you find that someone else is making, selling or importing a seat with four legs, you can take them to court and make them stop. You can also take away any profit they made. Patents are powerful because you can monopolize the seat-with-four-legs segment of the chair industry.

A patent can be licensed and sold just like any other property. If you decide you do not want to be in the chair industry, you can license the patent to another company and they can make chairs and pay you a license fee. Or you can simply sell the patent to them outright and let them do what they want with it, including selling it to another company.

However, success brings competition. If your chair idea gets popular, someone can make a competing chair. Consider a chair having a seat and only three legs. Since your patent requires four legs, a 3-legged chair will not infringe your patent and they are free to make and sell them all they want.[4]

A Call to Arms

Other people can patent improvements to your chair. Let's say, hypothetically, that somebody else sees your chair and decides it would be better with armrests. So they invent a four-legged chair with armrests and get a patent on it. That patent gives them the right to prohibit anybody else from making, selling or importing a four-legged chair with armrests, but *it doesn't give them the right to make a four-legged chair with armrests.* To do that, they would have to first make a four-legged chair which is covered by your patent. Unless they have your permission, you can stop them from making the four-legged chair they add armrests to. So, the two patents are intertwined; they need your permission to make their chair with armrests because your invention is included within their invention. You have the right to prevent them from making any four-legged chairs and they have the right to prevent you from making a four-legged chair with armrests.

Savvy business people know that in situations like this, it's best to make a deal with the other patent holders. They also know to check for related patents before buying a patent. So it is important to remember that having the right to stop others from making a product does not always give you the right to make the product yourself!

Because patents grant a type of monopoly, entrepreneurs tend to overvalue a patent. They think if they have a patent then nobody

[4] Why didn't you think of the three-legged chair? Creativity is an important part of the patent process because you should look for all the alternatives and patent them too!

will try to knock off their product. That's not true. If your product is a success, competitors will arise. It costs a lot of money to enforce a patent; merely having one is not enough, and this cost needs to be considered when contemplating getting patents.

Patents and Creativity?

We all create naturally. Human creativity just might be the Earth's greatest natural resource. (And arguably its greatest threat.)

You don't have to be wildly artistic or creative to have an idea that's patentable. It just needs to be unique. Patents have very little connection to the amount of creativity behind them, if such a thing can be measured.

While some creations might be labors of love, the kind of innovation that goes into creating a business is mostly just hard work. As Edison so famously said, *"Genius is one percent inspiration and ninety-nine percent perspiration."*[5]

That is what patent laws are designed to protect— the creative thinking, hard work, money and other assets that you invested to turn your idea into a marketable product.

Creativity Example: Software

The need to protect creativity is obvious in the software marketplace. If you have a great idea for a software product that manages a database more efficiently than everybody else, and you go out and start selling it without the advantage of a patent, the bigger companies will just steal your idea and incorporate it into their product. They're willing to bet that you don't have the financial resources to prove in the market that your idea is better, and they're probably right. Most people can probably think of at least one dominant operating system that's famous for just that; i.e., incorporating other people's ideas into their products.

[5] But Mark Twain also said, "*Thousands of geniuses live and die undiscovered - either by themselves or by others*."

Inventors have to face the fact that a good idea will be copied. A patent gives you some protection for the money and sweat equity you invest to take that good idea public. But patents aren't bulletproof. Most of them have work-arounds. If you're successful, your competition will find those work-arounds unless you find them first.

The Generic Drug Deal

You're probably familiar with generic drugs. They're a good example of how society ultimately wins. Simply put, a pharmaceutical company discovers a formulation that effectively treats a disease, and they get a patent for it. The drug has a generic name (omeprazole, for instance), and a trademarked brand name (Prilosec).

For about 10-20 years, the patentees have the right to exclude others from making omeprazole while they make it, sell it at whatever price the market will bear, make back their investment, and, of course, make their profits. Once the patent expires, any other company can also make that drug, and market it under its generic name or create their own brand name. Generic drug manufacturers watch the patent database closely and gear up their operations so they can be in the marketplace as soon as the patent expires.

Even though the word summons up some odd connotations (thanks to brand name marketers), all "generic" really means is a drug whose patent has expired. The drug's formulation and effectiveness are the same; only the name has reverted back to its scientific generic name, and different companies are making it. Today, generic drugs are everywhere – thanks to the investments made by pharmaceutical companies and to the patent system.

Provisional Patent Application?

One affordable option for patent protection is the provisional patent application. Provisional patent applications provide a way for entrepreneurs to file their invention with the US Patent Office and delay filing a more formal regular patent application for up to one year. The key benefit to filing a provisional patent application is the freedom to shop your idea to prospective investors and customers while protecting your valuable invention from the risk of being stolen – because it's already filed in the Patent Office. Once the application is filed, a person cannot come and back-date your idea. Of course there may be other aspects of your business that are best kept secret, but once the invention is recorded in a patent application, it's protected.

Provisional patent applications are initially more affordable than a formal patent application because not all the legalese is required and informal drawings can be used. However, to get the full benefit, you will need to file a formal application within one year.

Advantages of Patents

Because patents confer a sustainable competitive advantage they can be very powerful. But before discussing the advantages to patents, you should know that the biggest disadvantage to patents is the relatively high cost as compared to other forms of intellectual property. That being said, startups are often not aware of the full range of advantages that startups can get from a patent.

Intellectual Property and Investors

Start-up companies have to compete for investor dollars, and having a patent, trademark, copyright, or trade secret gives you an advantage that pleases investors. Investors see ownership of intellectual property as one of the ways their investment will pay off for them. Patents can also limit the downside of their investment because if the business fails, they can still license or sell the patents to another company who may be more successful.

Since investors do not sign confidentiality agreements, they often suggest that entrepreneurs file for a patent before discussing their invention with them. This has the added advantage that the entrepreneur has to convince a patent attorney they have something worth patenting before the investor spends any time evaluating the opportunity.

Patents to Block Competitors
Remember, a patent is a negative right, not necessarily a positive right. Therein lies its power: You can patent *what you're doing*, plus you can *also* patent whatever you think your competitors *might do,* making it more difficult for them to encroach on your business in the future. There are even companies that specialize in taking a known invention and trying to patent all the variations on the idea.

Patents as a Marketing Tool
In the minds of many consumers, a patent implies a superior product. Sales people like to brag about their products being patented because it conveys the idea of novelty. Companies with lots of patents are considered cutting-edge. Think Apple. The ability to label your product "Patent Pending" may provide a marketing advantage in your industry.

Patents Protect Investment
When you look at patents you have to look at them as an investment made to protect your business, either by locking up what you do for your business or preventing others from doing what you're doing, or getting close to what you're afraid they might do.

Collectively, all your intellectual property has some kind of value for your business. The issue is matching that value with your investment cost, determining how it will affect your competitive position, and how it will help grow your business.

Expensive – Is It Worth The Cost?
Unfortunately, patents can be very expensive. So, as a business person, you want to pay careful attention to the cost of getting that patent versus all the other things you could be doing with the money – especially if you're a startup company where sometimes the funds for a patent can be much better spent on things like marketing. Of course, trademarks, copyright and trade secrets can also be expensive if you end up in a court battle.

Patents almost always have a significant upfront cost. Timing this cost can be important. So ask yourself a few questions:

- Do you need the protection now?
- Should you test the market first?
- What if you're not really the first person to come up with the idea?
- Do you have the resources to defend your intellectual property?

Understand that if you don't actively exercise your right to stop others from copying you, those rights might be lost. There is no set formula, but you will need to weigh the financial impact of a patent against the level of protection it provides your business. The budgetary hit might slow your growth rate, but the exclusivity afforded by a patent should allow you to grow in a more sustainable manner.

Should I Patent?

Don't succumb to the pipe dream; merely having a patent won't make you rich. Patents are expensive to get and expensive to enforce, and often not profitable.

Before deciding to patent, consider that a cell phone isn't an invention - it's a collection of inventions. These inventions range from the operating system, to the touch-screen, to the radio transmitter. Some people claim there are over 20,000 patents involved in a modern cell phone! For the startup, the trick is to identify the key technologies and patent them. A key technology is one that makes your product faster, better, or less expensive than the competition. In other words, a key technology provides a major competitive advantage.

When You Probably Should Patent

If your invention does something truly surprising, like turning straw into gold, then obviously you should patent it. However, most inventions are relatively simple improvements over well-known technologies. One quick way to determine if an invention is worth patenting is to honestly ask yourself how hard it would be to design around your invention. If it's easy to design around, then don't patent it. However, if you cannot design around it easily, consider patenting.

Can your invention be used in multiple products or is it a one-trick pony? If your invention has a broad application, then patenting might be a good idea because it can help generate multiple revenue streams. Are there other companies (besides your competition!), that would like to license your technology? The more there are the more valuable your patent is likely to be.

Can you calculate the amount of money (or time) your invention saves? People see the value in saving money, so consider a patent for your money machine.

If you are planning on selling your new business quickly or taking on investors, patenting may be a good strategy. A large patent portfolio might help you get a better selling price or a better term sheet from investors.

If your product is very visually oriented, then consider design patents. They are easy to get, less expensive and easy to enforce. But their value is best for companies whose products have a unique look because they protect the "ornamental design" of a product. Especially if the unique look is associated with a company's image. Think Apple, Nike, and BMW.

If your invention is in a fast-moving technology area, you should patent if it's a very forward-looking invention, but not if your invention is likely to be obsolete soon.

When You Probably Shouldn't Patent

If your invention can be kept a secret, then don't patent. Recent laws have made trade secrets stronger. If it's hard to tell from your product how it was made or what's in it, then trade secrets should work for you.

Even software can have trade secrets – especially if part of the work is done on your server and is not exposed to the public. (See *Trade Secrets* on page 15 for more information.)

If your invention is merely a better Google or a better Facebook, it's probably not worth patenting. Google and Facebook have teams of people making a better Google and a better Facebook. Your invention is unlikely to compete with them.

If you can think of other, easy ways to do what your invention does, then maybe you should not spend money patenting it. It won't give you value for the cost. More importantly, the invention is probably not critical for your product.

If your invention only has a few potential customers, then it is probably not worth patenting. Take the automotive industry as an example. There are less than a dozen major car manufacturers. If your invention only has value to a car manufacturer, you will have a hard sell because the market is too small. Besides, they have teams of creatives designers already working on the problem you solved. With a small, specialized market, you are not likely to see a return on your patent investment unless you bring something truly unique to the table.

Maybe Patent

Most startups are in this maybe category. As a rule, if you are not sure you should patent, then don't. Also, inventors have a one-year grace period to file for a patent. This grace period starts when you first offer the invention for sale or use it publicly. While there is a risk that another inventor might file for a patent before you, knowing the market for your invention will help you decide whether to patent. So if you are unsure, get it on the market and see if your product is worth it.

Patents last about 20 years, so eventually your patent protection will run out. When that happens, traditional market forces will dominate.

In other words, brand equity and lower costs will be the driving factor that keeps competition away. If you have a product that is likely to have a long life span, then your money might be better spent on building brand equity and lowering costs.

Finally, creative people are creative. Most don’t have a single invention, they have dozens of them. If you choose not to patent, don’t worry. Another opportunity will come to mind.

Flying Solo

Anything worth doing is worth doing badly.
- G. K. Chesterton

Despite ample warnings about getting professional legal help, entrepreneurs often act as their own lawyers. Let’s face it, a lot of what lawyers do is not rocket science. Here are some resources if you are inclined to act that way.

Do It Yourself IP

This section includes tips on how to get basic protection for your invention without spending a lot of money.

DIY - Trade Secrets

Reread the section on Trade Secrets on page 15 to see the minimum requirements. Trade secret protection is affordable, but make sure you actually and vigorously protect your trade secrets. Don’t even disclose them to investors or at least make them sign non-disclosure agreements if you do. To reiterate:

1. Make sure secrets are actually secret.
2. Mark them as secret.

3. Limit disclosure to only necessary parties.
4. Make everyone with access sign a non-disclosure agreement.

DIY - Copyrights

Go to the website Copyright.gov and visit the tutorial sections. The material you want to protect can usually be uploaded (along with a fee) and you'll have the protection you need. The best time to register your work is before you make it public but do it as soon as you reasonably can. Also, it helps to mark your work with the copyright symbol (©, the letter C inside a circle), or the word "Copyright", followed by the year of the first publication of the work and the name of the copyright holder. These two steps will give you more options for enforcing your copyright including the ability to collect higher damages and legal fees.

DIY - Trademarks

If you are going to try to do your own trademarks, take the time to read a good "how-to" book on the subject. Nolo Press sells a variety of legal books on line that can guide you through the process. When you file, you should file for both the name (i.e. Nike) and the logo (the swoosh) as two separate trademarks. This will give you more options for marketing your product. If things do go wrong when applying for a trademark, you will probably need an attorney to get you out of trouble, so take the time to read the book or hire an attorney.

DIY - Patents

Like trademarks, the basic information required to file a patent, especially a provisional patent, is not hard to compile and file online with the Patent Office. What patent attorneys offer is advice on whether to file for a patent, and the art of acquiring stronger and broader patents.

Like trademarks, if you are going to draft and file your own patent application, spend some time and read a good guidebook on how to do it. A valid patent application has to tell the public how to make your invention and how to use it. In general, the more detailed the instructions, the better your application will be.

Consider filing a provisional application, then having your patent attorney prepare the formal application a year later. This will give the attorney a chance to fix up things if needed.

SECTION III

Building the Business

Risk Management

If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem. - J. Paul Getty

When you are starting your business, there are many possible pitfalls. This book is designed to help you avoid the legal ones by pointing out some of the general legal principles that are helpful in a lot of situations. One of these is the "risk control" principle. The idea is simple - never get yourself into a position where you can be seriously harmed. You run into this principle all the time although you might not be aware of it. For example, the idea of a credit card spending limit is to protect the lender if things go bad. The credit card company's maximum risk is only your credit limit - an amount that they can afford to lose if necessary. Also, credit card agreements are full of terms that protect them, including a clause that lets them change the terms of the agreement at their sole discretion! They keep their risk at a minimum.

So how does this apply to my startup? It's easy - make your startup dealings small so that all of the founders only have minimal risk if something goes wrong. Ask what would happen if this team member left or didn't perform? If it would hurt too much, you've broken the risk control principle. Plan your startup agreement so that you can still thrive if a founding team member doesn't work out.

The risk control principle applies in other areas of your business as well. Some examples:

- Structure your agreements with vendors so that the burden is on them to perform before you have to pay them.
- Never let your accounts receivables for a single client get higher than you can afford to lose.
- Never build a business on a single large customer. If they leave or stop paying you lose it all.
- Always go into negotiations with the ability to walk away if you cannot make a deal. You'll get a better deal that way and avoid unnecessary risk. Let your competition get stuck with the bd deal.
- Negotiate contracts with logical milestones and payments to protect you if something goes wrong.

The biggest advantage to the risk control principle is that it avoids lawsuits. If a customer only owes you a little bit of money before you stop doing business with them, then you can swallow your loss and walk away with minimum harm. Likewise, if a co-founder leaves the company early, there should be no serious harm to the company and no need to deplete the company's limited resources on lawyers.

Working with Attorneys

There are a couple things about using attorneys that startups need to know, and these apply not just to attorneys, but professionals in general.

The recommended time to employ an attorney is before you need one. Your CPA's job isn't just to represent you at an audit, but to set up your books and file your return properly, <u>before</u> you have an audit. Similarly, a lawyer works the same way. By building a relationship early, you can (hopefully) avoid time-consuming and expensive litigation later.

Separate Legal Advice from Business Advice

Do not assume that your attorney will be an expert on how to run your business. Attorneys serve a legal function. Their training is generally not in the business world. They know the legal structures of corporations and how to get things done through the courts. But they don't necessarily know how to negotiate, or even recognize, a good business deal.

Your lawyer may know how to draft a contract. However, drafting the terms of a contract is very different from negotiating the contract itself. You and your lawyer have very different mindsets. As an entrepreneur, you get rewarded for taking risks. Your attorney gets rewarded for helping you manage those risks. Their instinct is to protect you in whatever deal you're trying to make. But the question of whether it's a good deal, or a bad one, is not necessarily on their radar. Your job is to learn from your attorney how best to manage the risks you know you're going to take. For example, learn how to set up employment agreements or stock option plans that work for you.

Business is business; law is law. Again, avoid the mistake of giving your attorney too much business credit; they're usually only looking at the legal aspects of what you're trying to do. The same is true for other professionals you hire.

Follow Your Attorney's Legal Advice (unless…)

If the first mistake is seeking business advice from a lawyer, the second mistake start-ups make is seeking legal advice from their attorney – and not following it. The better attorneys are motivated to keep you out of trouble. If you have a good attorney who understands a little about your business and they give you some legal advice – take it!

Then again, it's perfectly okay to ask, "What happens if I don't?" After exploring the possibilities with your attorney, then make your decision. At least it will be an informed one. Some of the best entrepreneurs routinely ask us to explain what happens if they don't follow our advice. Entrepreneurs are rule-breakers.

Manage Your Costs

Be proactive in managing your attorney costs. There are a few simple things you can do to keep your attorney costs more affordable. As mentioned above, the first thing is to follow their advice. Secondly, don't just throw the ball into the attorney's court and say, "Here, it's your problem. Solve it." You know your business better than they do, and you should be able to provide some level of direction on how to approach the problem. By withholding your expertise, you are forcing your attorney to learn your business on their own, and they're going to be billing you for all the hours they spend learning things you could have told them for free. Moreover, since attorneys are trained to avoid as much risk as possible, including risk to themselves, their research will naturally be in-depth, time consuming, and costly.

So don't leave all the work to your attorney. Give them as much as you can. If you're going to them for something like a patent application, it's a good idea to have a written description of what your invention is and how to make and use the invention, along with a few sketches. The more time the attorney spends trying to grasp what you're doing, the more billable hours they're going to have. If you just explain it to them at the very beginning, the attorney will be able to hit the ground running, doing what they do best, doing what you're paying them for (their job, not yours). That is going to save you money.

Build a Rapport

Most people find attorneys through some type of referral. But referral or no, you want to make sure your attorney is a good fit for your needs. Be sure you can establish a good rapport with them. Do they understand what you're talking about, at least at a concept level? Can you understand their responses to you? You can't expect them to know the nuances of your industry, but they should be familiar with the concerns of a startup and/or small business, and more importantly, you should be comfortable talking with them about what's important to you.

Hopefully, you're going to build a relationship with the attorney that's going to last as long as your company lasts. You're going to need someone you can work with through good times and bad and someone you trust enough to share the very most intimate details about the company's operation—even things you would not want made public. So, take the time and do the research to find someone you really like, trust, and respect. Ask around and check referrals.

Size Matters

You're better off being the proverbial big fish in a small pond than vice-versa. Don't fall into the trap of wanting the largest law firm in the world to represent you. Being a small fish in a big pond is not going to get you top service. That's reserved for the bigger, wealthier clients. (I don't want to say that all attorneys do this—but it's pretty much the norm for the Darwinian reality of this fish-eat-fish world.) What you want is a law firm that specializes in businesses your size, and somewhat larger. The more important you are to them, the harder they're going to work to keep you happy.

Here's a tip: If the attorney doesn't return your message fairly quickly, scratch them permanently. You shouldn't have to ask twice. Unfortunately, the profession has a problem with people who think it's perfectly okay not to return telephone calls. There's a German expression that translates to, "No answer is also an answer." In this case the answer is, "Whoever you are, you're not important." And to them you're not. What you want is an attorney to whom you are important, someone that you feel welcomes your contact and values you as a client.

The Legal Stuff

The best way to predict the future is to create it.
- Peter Drucker

Besides the four major categories of intellectual property, there are other tricks available for startups to protect their IP. The goal is to keep your IP clean and avoid costly fights later. No startup wants to spend money on lawyers, so here is some advice and "war stories" that will help keep your IP safer and your legal costs lower.

Some of these topics might seem a little too negative, but they are all based on cases that have crossed my desk, often as a result of a failed startup. In each case, a little care on the part of the founders would have made their lives a whole lot easier.

Ownership of Intellectual Property

Ownership is one of the most often overlooked topics for young companies—not just for the business, but for all of the intellectual property. Startups often assume the company will own it all, but often things go bad quickly and ownership becomes a legal issue. The question of "who really owns the intellectual property?" might sound like a really basic question, but oftentimes it's hard to answer. If there are joint developers, or multiple stakeholders with valid claims of ownership, then things can get messy. Here's how this happens. You have an idea for a product or service that you want to offer, and, like most people, you discuss it with friends. These friends can contribute a little to improve your idea – this makes them inventors as well. This process is a lot more common than you might think, because people feel the need to contribute their thinking to your business idea. After all, that's why you're talking with them in the first place. A simple sentence like "how about adding …" or "You can also..." all lead to parts of the invention and that might make them joint inventors.

Normally it's not a big deal, except in some cases. For example, in the case of a patent, it needs to be clear who the inventor really is in order to get a valid patent. Under patent law, <u>every</u> inventor must be listed, or you risk losing your patent rights altogether. Usually when you're starting off, the ideas don't seem to have all that much merit and no one really cares. Besides, who wants to fight over ownership when there's no money on the table? However, if the idea is successful, people with very remote relationships to you will show up claiming to have some type of ownership interest. Disgruntled (and even gruntled) ex-employees are famous for this. So be clear about inventorship, and get it in writing.

Work-for-Hire

There's a legal concept called "work-for-hire," which is kind of a default rule that says if you pay someone to develop something for you, then you own it. For example, if you hire someone to produce an invention you thought of, or to make some marketing posters that might be copyrightable, and you paid them to develop these things for you, then you own the rights in the intellectual property they made. If a work is "made for hire," the employer—not the employee—is considered the legal author. However, since there is nothing in writing, disputes can and will arise. These can be costly and derail a startup business, so it's best not to rely on work-for-hire if you can avoid it.

Work-for-hire disputes can arise in any area of intellectual property, but it's easiest to understand in the area of copyright. For copyrights, it's one thing to have the actual piece of art, it's another thing to have the right to copy it, reproduce it, and sell it. Copyrights also come with a certain "moral right" – the right for authors to be recognized. It's a right of attribution: the right of artists to be associated with their work. Consider the late, not-so-great, but financially successful, and well-known painter, Thomas Kinkade. As the trademarked "painter of light," he created hundreds of paintings of rural cabins with a fire in the fireplace and light coming out of the windows on a dark evening. This genre belongs to him. And his name, his right to be associated with that type of art, belongs to him as well.

Often disputes arise in copyright because the employee is working in a kind of grey area. Was the work actually created just for you? Did they originally intend it for you, or someone else? Are they delivering a modified version of something that they previously created for others (or perhaps just for their own enjoyment)? Think software - are elements of the deliverable modifications of the work of others (like source code) which you will need to pay license fees for? Did they work on the piece outside of your stated work hours, or off premises? There are many factors that can bring your ownership of work-for-hire creative products into question. That's why it's important to be absolutely clear on which rights you are paying for. and the way to do that is to not rely on work-for-hire, but instead have a written agreement.

Outside Experts

Consider a software development project where the software developer is being paid by you to write software for your business, but they're using code, procedures, and subroutines that they have developed and used before they started working for you. When I was in software development and people would ask me to hand over all the rights and the code, I would often have to point out that I'm actually re-using code that I've been using for years, and that other people may have actually paid me to develop for them. Sometimes it's my existing personal code that I would keep in my little bag of tricks and pull out when needed. Often other developers would loan me or give me executable code of uncertain origin that I could run as part of my software, or I would buy development tools that limit my ability to pass on rights to that software. Of course, my contracts were very clear that I could not provide an absolute license to all of the source code. My job was to deliver a working solution to a real-world problem, not to create a totally original work of art. Very often industrial artisans, like graphic designers and web developers, use pre-existing art to create solutions and clarity of ownership is important.

Whatever is developed for the company should belong to the company. Have a good employment agreement, especially for contract employees, which clearly states that anything they develop for you on this project belongs to you. All of <u>their rights to it</u> belong to you.

Get it in Writing

Even the dullest ink shines brighter than the brightest memory. Have a signed contract in which an employee or vendor agrees to transfer their rights to you in exchange for their employment. Intellectual property ownership then becomes a permanent non-issue, assuming you keep your part of the agreement by paying them.

There is no good substitute for having a well-written agreement among yourselves as to who actually owns the intellectual property that you're having developed. Even if it seems a little awkward among friends, you need to say, "Okay, who owns this? Who invented this, or what are we going to do with it?" You hate to ask that question and risk ruining what could be the start of a really good relationship, but it needs to happen, and the sooner the better. Remember the old adage, "Good fences make good neighbors." That's just as true for intellectual property as it is for a farmer's property. It's especially true in the area of partnership agreements. Finding good partners is an important but daunting task; the sooner you put your heads together to discuss and codify your working relationships, the sooner you can get a feel for your partners' business acumen and general reasonableness. If they're inept, incorrigible, or insane, it's better to find out early and make your break before any serious money starts changing hands. (And that's just the faults starting with the letter "i".)

Make the agreement clear about <u>what</u> the agreement covers. If you're dealing with an employee, and your business is in the life science industry, make sure your agreement specifies life science work. Don't try to gain ownership of everything the employee does. For example, if the employee is a hobbyist mechanic on weekends, they work on automobiles, and if they develop tools for working on automobiles, you're going to have a hard time making a claim that you own that invention because that's not in your industry and the employee didn't use any of your resources for the invention.

When you make agreements for the ownership of intellectual property, each type of intellectual property has a different set of rules. So, you want to be very clear on these agreements and probably consult with an attorney before you do it. A few tips:

If you're paying someone to invent and that results in a patent, you want to make sure that the contract stipulates that they grant the patent to you, and also grant any related patents to you. Remember, people make improvements on patents and you want to make sure you own those improvements as well.

It is easier to deal with the Patent Office if you have cooperation from the inventor, so be sure to get the employee to agree to cooperate with applying for the patent and any derivative patent, which will also be assigned to you.

With copyright, you want more than just the right to use the image or the creative work; you want the right to copy, reproduce it, and sell it. If you're the employer, you want all the rights, however, if you're an employee, you might want to reserve some of those rights for yourself. So maybe your employer can use it for a limited time, but you actually retain the rights for any other usage beyond the original intent of your employment. This would arise in a situation in which creative employees create characters that are used for marketing. You want to make sure that the employer can use it for their intended reason, but maybe the employee wants to keep that character because they'll use it down the road as they do other things. Often creative people have a stock set of tools they use for images just like software developers have a stock set of software they use in the line of development. So you want to be careful with your employer-employee relationship and be clear what is included in this contract for intellectual property.

One common pitfall is in the area of software development, where it's not uncommon for a couple of developers to meet or a developer and a financial backer to meet at some meet-up group or social function and decide they want to pursue a particular business. They often meet and just start working together without having anything in writing. If you've seen the movie *The Social Network,* that's exactly what happens; they actually walk out of a bar, go back to a back patio, and over a beer, they divide up the company which became Facebook. It's nice to have these agreements and start on your business right away, but a few words in writing, even one simple hand-written sheet of paper, would have really protected everyone's interest in the new company. Remember, even the faintest ink shines brighter than the brightest memory.

A simple agreement is usually better than no agreement at all. And if the company fails, it's nice to know who gets what. If you start a company, and you try to find investment backing for it, and the investment backing never comes through, who gets the software at the end of the day? The developer? Are you going to split it? Often, if a company is trying to find venture funding or angel funding–and they don't get it—there'll be some animosity among the company founders. If personal dynamics change after a failed business venture, you cannot expect people to negotiate with the same spirit that they started the company. It's nice to know—beforehand—what will happen with the software that's developed.

It's also perfectly reasonable to specify time conditions saying the partners won't compete with each other for a while if the venture fails. These are the types of things that protect everybody involved in a startup if the project doesn't go forward. If the people who are doing the development know that they get to keep whatever software they develop and use it for their own as long as they stay out of a competing area of business, they might be more amenable to an agreement. Regardless of whether the venture fails or succeeds, everyone's clear on exactly who has what. It keeps the lawyers away, it keeps everybody out of a lawsuit, and worst-case scenario—at least you're still good neighbors.

Consider Emails

As much as I recommend a well-written agreement, if you can't get one, at least make an email record of what you agreed to do. Here's how it works. "Thanks for meeting with me today, just to be clear I will do … and you will do …." A series of short emails setting out what you agreed upon and what your expectations are can be very effective in settling disputes that arise later. They might not have all the formalities of a written contract, but if your email exchanges have the basics of your agreement, well… that's better than nothing. Besides, getting in the habit of following up meetings with emails helps keep projects on track and keeps all the players on the same page.

The downside to emails is that if there is a disagreement about what was agreed upon, an email might not clarify things. People don't read emails in depth, so they often cause unwarranted confusion. Meet person-to-person (or by phone), clarify things, and then send a follow up email.

Keeping Secrets

The "secret sauce" of every startup is the one solid product or activity that will separate your business from all the others. Disclosing your secret sauce recipe to the wrong people is always a bad idea. Be careful, but not paranoid. Some startups never start because the founder is too afraid to tell anybody his big idea. At some point, you'll need to trust someone, because you will need that person's help to start your business.

Although there are no hard and fast rules, there is a kind of a hierarchy for information sharing built on the level of risk you might suffer. Most startups fear that major companies are the most likely to steal their ideas. True perhaps, but big companies suffer from inertia, and even if they know your idea, they are very slow to act. Similarly, small businesses are also not in a position to act, because they tend to be resource limited. The people most likely to harm you if they have your secrets are the companies that are already in your market space and can easily adapt to your idea. It's your job as an entrepreneur to identify those threats and keep them at bay. Whenever possible keep your secret sauce to yourself, until you need to disclose it to another person.

Startup Ownership

The type of business you need depends on how you plan to make money. If you are simply licensing your invention, you probably do not need any business entity. If you are selling a product or service, or planning to raise money, then you most likely will want to be a corporation. Generally, however you want to avoid sole proprietorships and partnership because they don't provide the liability protection most startups want. Your better options are a limited liability company (LLC) or a corporation. Your investors, attorney, and CPA can help you decide which is best based on the tax consequences.

Limited Liability Companies (LLC) work well for investments in long-term assets like real estate, but become difficult if you are raising funds for regular businesses, or are expecting other ownership changes. Therefore, most startups are corporations because they are easier to manage and in some states like California, pay less franchise taxes.

Corporations may be either "C" corporations or "S" corporations. The difference between an "S" corporation and a "C" corporation is only how they are taxed. They are legally and structurally identical. Ownership is measured by shares in the company's stock; the more shares you have, the more ownership you have. The shareholders own the company and meet once a year to elect a Board of Directors. The Board of Directors then appoint the executive officers (President, Vice president, etc.). The Executive officers and the board member are employees of the company and are treated that way. (They all get employment agreements!)

Regardless of the structure you choose, this chapter provides some basic advice about company management for the early days of your business.

Startup Agreements

You do not need to decide on a business structure right away, but when there is more than one person starting the business, get a startup agreement as soon as you practically can. These can be changed along the way, so get something in writing sooner rather than later.

Usually, the biggest problem people run into is clarifying expectations as to who's going to do what. If you've seen the movie *Social Network* (and you should), the whole movie is framed around this idea of who is expected to do what, and what they'll get in return for it.

There are a few rules you can keep in mind for start-ups and young companies that will make it a lot easier for everyone to participate in the life of the company and hopefully make it, and themselves, much more successful.

First, as with like everything, particularly legal advice, get it in writing. Remember, *even the faintest ink shines brighter than the brightest memory.* That's why you want to get things down on paper; years later, or months later, sometimes just days later; you're going to need to know exactly who agreed to do what.

When you and your kindred spirits are first brainstorming a business idea, it's not clear whether or not the business will be profitable. It's easy then for everybody involved to tacitly agree for the sake of moving the idea forward. The process is fun and exciting. What could possibly go wrong?

What Could Possibly Go Wrong?

Once it's clear that there's money to be made, things change. It's only natural. Two or three people get together, and someone says, "Hey, this would be a good idea. I can write code for that." Then they'll split up into conventional roles like techie, salesperson, money person and things are fine for a while. However, when the money seems closer, people get resentful. The programmer feels he's doing all the work and the salesperson still hasn't sold a thing. The salesperson resents the techie because he has nothing to sell yet. And the money person is frustrated because he's trying to find funding for a product that doesn't exist and has no customers.

This is where a startup agreement can really help keep things in perspective.

Even with the best intentions, somebody will drop the ball and fail to deliver what everyone thought they were going to deliver. Whether this is due to incompetence, insincerity, outside commitments, or a short attention span, it doesn't matter. It didn't happen. It's not going to happen. It's their fault. Even though they're a founding member, they need to go. You need to find someone else who can get the job done.

Or perhaps you are all working day jobs and you plan to build your business by working hard, part-time, at night. And at first you do. However, the afterglow of conceiving the great business idea eventually wears off, and reality sets in. The day job is tough. You come home tired. You kick back, crack a beer, sip some plonk, have some dinner, catch up on F-Troop. Too late to work now. The weeks drift by. The Big Idea drifts away… Your great business is not getting built.

With a written agreement, you can make allowances for when people do not perform. For example, the ability to replace them with someone who will do the job. If you have a hard time getting a well-written agreement, consider emails with details (see *Consider Emails* on page 37).

The Problem of Dormant Partners

Many startups never get the traction they need. What's worse is that you may now have a chain of ownership in your intellectual property that may prevent you from doing anything with it. People may have contributed on day one and they're still hanging on to the company, or they still have some rights in the company, even though they never contributed any more after that. Besides having a well-written startup agreement, structure your ownership cleverly too. Read on to see how.

Initial Funding Plans

Your operating agreement should be very clear on how you intend to fund, and how to change the agreement. For example; it's very common to start off thinking you can bootstrap a company only to find out that you can't. Things get serious when there is real money on the line. Bootstrapping means you're going to pay for it all yourself without outside investors. However, if you find out that the software is a bit more work than you thought, and the marketing is even more work than that, or you finally see some unforeseen obstacle, then you might need to change the bootstrap approach into something that will attract investors. Should that happen, you want your operating agreement to be very clear on how those decisions will be made.

On Bootstrapping

Before you fund a company, you're a bootstrapper, one paying one's own way. Bootstrappers need to conserve cash. Moreover, bootstrappers need enough cash to get *Product One* out the door and into the hands of a paying customer if they can. Bootstrappers often make the mistake of negotiating away a lot of their company to get enough help to get *Product One* launched. Some have even been known to promise away more than 100% of a company.

Use your startup agreement as a tool to keep track of who is in your business; everyone who participates in the startup of your business should be documented with a written agreement saying what they are entitled to, what they have to do to get it, and what happens if they don't do it.

If you can get to the point of having a product or service for sale, seriously consider bootstrapping your whole business. The less you have to give to investors, the more you can keep for yourself.

How to Cut the Pie

One common question is how to handle ownership of a company before the first product is launched. There is no easy answer. People ask "Why not just split the company evenly?" Bad idea. Let's say three people are building this company, and they all say "a third, third, and a third, what a good idea." Later, it turns out that the software guy doesn't do what he's supposed to do, or the person who was going to get the money doesn't show up with the money. The problem is these two non-performers each still own a third of the company.

A pie is not really a good analogy for how to divide owner shares, but it is the most common image. But, note that the pie changes size as you divide it up. For each person you add, or investment dollar you receive, the pie is growing larger. It is not how many shares you own, but how much value you receive. Your goal is to create maximum value, even if it means ceding more ownership to others.

If your company has a hundred percent ownership and you each own the 33-1/3%, there's no pie left to use to bring in somebody else when needed without restructuring your whole company. Instead, consider a deal like "Out of three people, we each take 10% and we reserve 70% of the company for future investors or any other partners we could bring on?" Good idea. This way the maximum damage anyone can do—even if you don't make an agreement with them and/or they don't perform as expected—is that they'll own 10% of the company. You can give another 10% to another developer and have them finish the work. Or you can give 30% or 40% to investors and get the money to hire somebody do the work for you. It's always a good idea to reserve part of the company for future needs.

Regardless of your corporate structure, specify the ownership in shares rather than percentages. It will be easier to bring in new people or re-allocate shares if someone leaves the business. Consider this. If 3 people start a business and each get a third and then one of them leaves the business, how would you divide up their 33-1/3% of the business? If instead the business was started by issuing a million shares and each cofounder gets 100,000 shares, they would still have equal amounts and if one leaves it is easier to divide the ownership among the remaining owners.

Now, I'm assuming in this scenario that it's a small company, that all the founders are working to create the company, and that you aren't immediately looking for a lot of money. If you're going to go with outside investors, angel funding or venture capital, you'll need to structure your company a little bit differently and you probably should talk to an attorney. There are rules that govern who can invest and having a poorly structured ownership scheme might prevent you from getting the funding you need.

But at least when you're starting out, you want to make it clear among all the founders who gets what, and save plenty of the ownership pie for other players; it will minimize the damage you can do to each other and leave the door open to outside resources as they are needed.

Vesting In

One way to allocate ownership among cofounders and early employees is to use time vesting. In essence each cofounder starts with a small amount of ownership shares and acquire more shares the longer they work for the company. Standard agreements usually start vesting after a year of working for the company.

If you bring on investors, they will often dictate how your vesting schedule will work. If you are bootstrapping, then you have more options.

Bootstrappers can use a little creative thinking on vesting. Consider this: instead of giving everyone 10%, give them an opportunity to earn their 10%. For instance, the software developer gets 2% for signing on, 3% for providing the beta test version of the software, and maybe the other 5% for producing the final product. Do the same with the money person. They get a certain percentage on the first pass of the business plan, a second when they have actually pitched a certain number of venture capitalists or angel investors, and the final percent when they actually turn up with some money. Do the same with sales and marketing people. They need to attain certain goals before they're fully vested into the company.

The serious drawback to this approach is defining those goals clearly and reasonably. Which is why most vesting is based on time spent with the company.

You want people to work together, to stick with the company, and avoid the temptation to jump ship. Their work is an investment in the future of the company. The operating agreement should make it clear that anything done towards the advancement of the business becomes the property of the business. This way a disgruntled cofounder won't be able to grab the source code and run off to start his own company. The company always has the rights to the software even if the software is not fully complete. This won't necessarily avert lawsuits, but it will reduce any unintended consequences or any bad results from that lawsuit because you have a clear path of ownership on all the intellectual property.

However you divide the ownership, you want to be very clear about who really owns this company. The answer should be short and clear. Nobody is going to want to invest in a company that sounds like a cross between *Survivor* and *Family Feud*.

More complex startup ownership structures are available such as convertible notes. In a nutshell, a convertible note is a loan that later converts into ownership in the company. Convertible notes can be used to value "sweat equity" – the work the founders do. Then after the business gets going, you can issue proportional ownership. Don't do convertible notes on your own – get and attorney because they can be very complicated.

"This Way to the Egress"[6]

Finally, an operating agreement should spell out what happens when the startup stage ends. You hate to think that your great product idea

[6] This phrase was made famous at PT Barnum's NY Museum. Barnum noticed that people were lingering too long at his exhibits. He posted signs indicating "This Way to the Egress". Not knowing that "Egress" was another word for "Exit", people followed the signs to what they assumed was a fascinating exhibit...and ended up outside."

might fail, but plan anyway. A company breakup is like watching a bad divorce – it gets ugly quick.

An exit plan could be executed by reaching a funding goal or a sales goal, attaining beta stage for the product, <u>not</u> attaining beta stage by a specific date, dissolution of the company, and every possibility in between. Who's going to get what at the end of the day? Often it's as simple as dividing up the assets and agreeing not to compete with each other for a short period of time. Software can easily be cross-licensed and domain names and trademarks can be sold to the partner who places the highest bid.

Often software developers think that if the business falls apart, they still have the software and they can go find other people to go forward with it. It might be a good idea to just let them do it, depending on what your contribution was (and compensation might be), but that kind of tradeoff should be spelled out clearly in the original operating agreement. You want to avoid having a failed company and a prolonged battle over who owns the software. Without a clear agreement, (and sometimes with one) stakeholders are often surprised to learn that they don't even own what they think they own. With a clear operating agreement, you should be able to dissolve the company with grace and style.

Have an exit strategy, even if it's a very simple one, written into your operating agreement. Remember; with a new company, especially in the high tech and the software world, you may create a lot of valuable intellectual property–even if you never produce a product.

MORE MARKETING RESEARCH- Sell It Without Selling It.

Test marketing

Once you have taken steps to protect your intellectual property and you have an initial team in place (even if you are the only team member!), you are ready to test market. You do not need to have aa final product, ready to sell, to test the waters. What you need is a presentation that conveys your product's benefits that will entice prospective purchasers to reach for their wallets and give you money.

Benefits – Not Features!

Inventors often assume their potential customer understands the benefits of their product. That's a mistake. Customers understand the benefits your product or service brings them. They want to know how fast the car will go. Then they will look under the hood. Don't get caught offering features without explain the benefit the feature provides.

The Minimum Viable Product

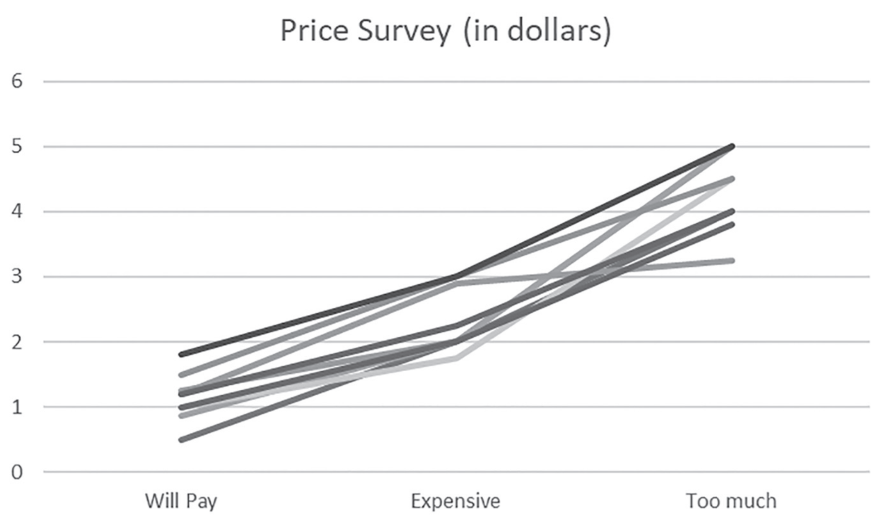
A minimum viable product (MVP) is a product with just enough features to satisfy early customers, and to provide feedback for future product development. The concept comes out of the "Lean Startup" model of product development. Shoot for the MVP initially and build out your product line later.

Getting an initial "value price"

Earlier I set out an initial cost limitation of 30% of your sales price. This is an initial limit to provide a starting point for measuring product feasibility. Now that you are talking to potential purchasers, you can start to acquire the information you need to get a realistic selling price. The easiest one is simply to ask them what they would pay for your product. No matter what they say, do not flinch! They probably do not see (yet) in the product, what you see. This number may be as much a measure of your sales pitch as a measure of the perceived product value.

The follow up question is to ask is how much would they consider to be expensive, but they would still buy? Finally ask them to tell you what the price would need to be where they would not buy.

Don't worry about how accurate these numbers are. Your goal is to get three numbers from each of your prospective customers. As your pitch gets better, these number will change. Once you have them you can plot them out and look for the sweet spot – the value price.



In this figure you can see the price information from a series of prospective customers. There is a small change in customer perspective at about the 2-dollar point. After that you reach the range where it is too expensive. The goal is to set a value-based price point. This is the point where customers see the value and buy the product. Any lower price is throwing away money. From the graph above, a price point in the 1.5 to 1.75 range is a good starting point. This is just below the point where most people think it is too expensive.

Before you settle on a final price, keep in mind the adage that it is easier to cut your price than to raise them. If you cut prices, people think they are getting a deal. If you raise your price, people thing they are getting taken.

Pre-sales - Kickstarter

One great gauge of how your product will do is to presell it. This means lining up buyers before you spend any money designing and building it. Also, if people pay in advance, then you can use that money to finance your operations.

Kickstarter, IndieGogo and other crowdfunding sites are wonderful at measuring customer interest and generating presales. However, there are several important caveats to using crowdfunding. The biggest is that to run a successful campaign you still need to spend a lot of marketing money. You will need a good video to show off why your product is a great product everyone should have. This will probably require a mock-up of a working product. Also, the crowdfunding sites draw a limited set of viewers. If your product appeals to a broad consumer base, then they might participate. However, business-to-business products are less likely to generate any meaningful response.

Also, the crowdfunding site administrators select projects that they think will appeal to their targeted viewership. If your product does not appeal to them, it is not likely to get good promotion and fail as a crowdfunding campaign.

Crowdfunding Equity

Yes, you can sell stock through crowdfunding. There are several reputable online businesses that do this and will provide the legal counsel you need. But before you do read the next section.

Financing Your Venture

Financing depends on your go-to-market plan. This is no clear path, so the topics presented here are to inform you of the possibilities and help you start on the right path.

Licensing – the Least Expensive Investment

If you are planning to only license your invention, then your financing will be minimal – you can do it yourself. If you are starting a company, then you will need a lot more cash.

Not all products are licensable. If you think yours is, then here are some suggestions to get dollars. Most major companies have some type of invention submission process. If you hunt around on their corporate website, they will tell you how to submit a product idea to them. Remember, they're looking for good products to sell just as much as you're looking to sell your good product. Those companies will also warn you that they won't accept unsolicited product ideas that you haven't taken some steps to protect. This makes sense because they don't want to get sued for stealing your idea. So, protect your idea using one of the legal means to protect it, like a patent. Often, they will include information on what they're looking for and what types of products they're looking to license. One warning –merely licensing is the least successful way to monetize an invention unless the invention is exceptionally unique. The people who would be interested in licensing are most likely already in your industry and are looking for ways to grow in that industry. That means they have domain knowledge, so if you plan to license your idea to them your product will need to provide a benefit significantly better than what is already on the market.

In the commercialization process, the most money goes to the person who takes the most risk. This means the people who shell out the most cash to design and build the product get the lion's share of the profits. Studies show that inventors who do not participate in the commercialization process, gain about 3-5% of the reward, while investors gain the rest. The money goes to those who execute. If you license, expect royalties in this range.

Starting a Business

The next option is to start the business. If you don't license, you are on a mission to get cash. To get that cash, it helps to put yourself in the place of the investor. The very essence of funding is getting a return on the investment. Investors are weighing their alternatives and you are the high-risk alternative. So, you have some convincing to do.

Begin with knowing the investor’s expectations. For example, institutional investors, like venture capital firms, like to see a tenfold return on their money within a few years. If you cannot show a chance to make that kind of return, you are probably asking the wrong people for money. Family and friends might be more forgiving and be more willing to wait longer for a decent return.

Investors bet on two things, the prospect of a good return on investment (ROI) and you - the entrepreneur. They say they bet on the jockey, not the horse. This means they are looking at your ability to deliver the ROI, not just on how good your product idea is. You have to demonstrate to them that you know the industry and you are using reasonable estimates for your financial projections. In other words, you have spoken to a lot of people and have done enough real market research to know what you are talking about.

By the time you start looking for investors you should have a ballpark estimate of costs of the product or service you hope to sell. More importantly, you should have some real feedback that supports your initial retail price. One thrust of this book is getting real, actionable information about whether this investment is worth the risk.

How much will you need?

There is a lot of information online about creating a financial spreadsheet for your startup, but they all share the same limitation – it is all a guess. You do not have access to any real data because you are just starting out. So, what do investors look at if everyone knows it is only a guess? They look at the reasonableness of the numbers.

If you have a reasonable guess for a selling price, the next step is to get a reasonable estimate for your cost to deliver the product of service. Note, it is not merely the cost to get your product built, but any other related costs too, like transportation, taxes, warehousing and the like.

If you have a software product, you will need to have an experienced developer provide you with a cost estimate to get the product out the door. You will also need to provide technical assistance to your users. For a traditional product, you will need to get a price quote from a designer or manufacturer. Ideally you will get several cost estimates.

Bootstrapping & Family and Friends – the Next Level of Investment

If you are lucky enough to have a business that you can self-fund (called bootstrapping), then the main task will be to keep your costs as low as possible until you get to revenue. Many people have so-called lifestyle businesses. These make enough money for them, but nobody invests in them. Investors want a return for their investment and your job is to show them how they will get that return. However, all businesses start here. If you can pull it off, bootstrapping or using money from family or friends lets you keep more control of the operation. If you can't get the money you need, then you will need to go to outside investors.

Review - One way to raise money is simply to sell stock in a private placement to a small circle of people. Prior to selling shares of stock you will need to detail your financial plan as best you can, set a stock price and have the stock sales agreements in final shape.

To issue private stock, you can make a private placement offering that does not necessarily need to be registered with the Securities & Exchange Commission (SEC). A number of exceptions are in place to allow the small business owner to issue stock without having to go through the lengthy and somewhat difficult process of registration with the SEC. However, the offering still needs to comply with state and federal laws. Check with your attorney before offering any stock for sale.

While selling shares of stock can provide you with much needed capital, it also means that you will be relinquishing some degree of control. Shareholders will have a say in electing directors of the corporation. They can also review corporate books and records and vote on key corporate decisions. One major benefit of bringing in stockholders is that you may be able to use their knowledge and business experience.

When selling private stock to start a company, it is likely that you will know most of your shareholders. Maintaining a good relationship with shareholders is important. They will be more willing to assist you and buy more shares if later if you keep them informed as to the operations and prospects of the business. The only successful way to deal with your investors is open, honest discussions on all the issues – even the failures because your investors may be able to help you. Also, if your business fails, and most do, then if those investors have faith in you, they might invest in your next crazy idea.

How Corporations Work

Corporate governance isn't as complex as most entrepreneurs fear. It's a three-part structure of shareholders, director and executive officers. Each has a role and knowing their roles is critical.

The people who own the company are the shareholders. They meet once a year and elect a Board of Directors. Other than electing the Board, they do not usually have any say in the operation of the company. They do, however, get the profits.

The board of Directors meets regularly and makes the decisions for running the company. Control of the Board means control of the company. Board members are usually elected for a term, often 1-year, but sometimes longer. The Board will have at least a Chair and a Secretary. The Board exercises its control by appointing the executive officers. The executive officers, President, Vice President, and others, serve at the whim of the Board.

The day-to-day operations of a company are run by the executive officers. They periodically report to the Board.

For small companies, one person can be all positions - the sole shareholder, Board Chair and President! As you grow, you can add others to the company structure.

Note: *Control of the company is through control of the Board.* Expect early investors to want control of the Board because that is one of the tools they have to protect their investment. For example, a 10 percent investor might want one seat on a three-person board giving them a third of the votes.

Lean Startups

One great model for startups to follow is the so called “Lean” startup. As the name implies it focuses on minimizing your investment until you find a business strategy that works for you. There are lots of books available on this model, but a quick read of the Wikipedia article will be time well spent. The model is great for software businesses and those that can quickly change their product offerings.

Incubators and Accelerators

One possible way to fund your business is to go through an incubator or accelerator. These are organizations that provide resources, usually in the form of training, expertise and sometimes a small amount of operating cash, in exchange for a part of your company. They may be private organizations, government or corporate owned, or affiliated with a university. Incubators generally work with very young companies trying to find a good business model for their unique technology while accelerators work with companies that already have revenue but want to grow faster.

Incubators and accelerators provide capital, training, advisors, a workplace and most other things a young company needs. They are ideal for companies that need a lot of investment and to connect to people with domain experience. They have deep human resources.

Like most investors they are looking for companies with the potential for high returns in a short time. They operate by polishing you up so that you are a good candidate to invest in. Then they introduce you to potential investors. They may have regular "pitch" events where you pitch your company to potential investors.

Incubators are becoming technology or industry specific. This means there are incubators that specialize in robotics, medicine, food tech, and the like. If you go this route, find an incubator that fits. Since more corporations are starting incubators, a company in your industry might be a perfect partner for you. Pay close attention to any deal they propose. They usually want some form of equity in your company in exchange for their help. If you are raising money, you are likely giving up equity anyhow, so it might be the best you can do, but be sure you are getting value before signing a deal.

Angels and Venture Capitalists

The conventional means of funding a startup is with professional investors such as angel investors or venture capitalists. Angel investors usually only fund up to a small amount, maybe $200,000 while venture capitalists will fund significantly more. Most companies start with angel investing and move on to venture capitalists later. These groups usually operate by collecting money from investors into a fund and then seeking out young companies for the fund to invest into.

Funding is done in rounds such as the early stage "seed" round, series "A" round, etc. Each round gets progressively larger. Lately the definition of these rounds is getting blurred so not much reliance should be placed on the name. However, each round of funding takes more equity, so that needs to be evaluated. At first you have an angel round might want about 25% of the company. Later you might have a series "A" round with a venture fund that wants 45%. With this in mind, the trick is to get as much money as you can for those percentages. If you are going to give up 25% of the company, sell it for as much as you can get. It is OK to ask for a lot but know your value when you do because they will force you to defend it.

Funding is based on a hypothetical company valuation. This is, at best, a working estimate of the value of your company. If they value your company at $2 million, then they would in theory pay $500,000 for a 25% share in it. As you can see, haggling over the valuation is how you settle the amount of the company you would trade for the investment.

When these professional investors choose to invest in you, they proffer a term sheet. This has the conditions under which they will fund. However, a better way is to have an offer with your terms (called “the ask”) to present to them first. This way you can set the expectations. The most common way for early rounds is to offer either a convertible note or a simple agreement for convertible equity (S.A.F.E.). the details of these are presented below.

Before you approach any institutional investor do your homework. There are plenty of ways to find these investors – even web-based databases of investors. Your goal is to find the right investor for your product or service. Learn what type of investments they like, early or later stages. Learn what technologies they like. If they know your industry, they can really help you. If you can, speak with other firms they have invested in to see what they are like. The institutional investors will appreciate that you’ve done your diligence. Moreover, if you impress them, they might go out of their way to help you find the right investors.

Watch out for institutional investors who may already be invested in your competition. You will give these investors a lot of your know-how and you may not want that being broadcast. Remember, they will not sign a non-disclosure agreement, so be very careful with what you disclose to them. Keep your trade secrets to yourself. They do not need to know the how of what you are doing – only the benefit of what you are doing.

Often investors will want to see that you have at least filed a provisional patent application before approaching them. This means you are “patent pending” and some of your IP is protected. Therefore, you can talk freely with them about your technology. While you may be enamored of your technology, they will most likely be more interested in the benefits your technology brings than how you do it.

Building Financial Projections

Your financial projections will form the starting point for your company evaluation. The key is to make reasonable assumptions in your estimates. That is where domain experience is extremely helpful because people who know the industry can tell if your numbers make sense. It might seem that company valuation would be based on the initial investment together with an expected return on investment. This seems to rarely be the case. Often there are other appealing aspects of a company that outweigh the financial projections. For example, traction (the growth rate), potential to disrupt an industry, or the social benefits, can significantly sway investors.

Earlier we looked at ways to set an initial price for your product and ways to get a cost estimate. Your financial projections are based primarily on how realistic these number are, so be sure you can explain how you got these numbers. Get a quote from a design firm or an engineer. Have some real market research prepared that you could use to show you have done your diligence.

Start with a sales forecast. Set up a spreadsheet projecting your sales over the course of three years. The gross profit calculation should be units sold times the price, minus the cost of the units and the cost of sales. That's right, you will need to estimate how much a sale will cost. If you are not comfortable doing financial projections, then get some help – you will need it. Once you get a gross profit, you can deduct expenses. There are lots of expenses to consider and you will need to make reasonable guess at these amounts. There are several financial plan templates available online that will help you, step-by-step, get a complete picture.

Don't guess at your sales growth rate. Try to base it on comparisons to similar products or trends in the industry, population growth, or some factor besides your belief that your product will sell like crazy. Investors don't like wild guesses; they want to see some reason why your sales will grow.

Selling Equity

Selling equity (as opposed to borrowing money) is selling an ownership stake in the company. There are several ways to accomplish this, and each way has its own advantages and disadvantages. One key element is to not over promise when you offer stocks for sale. Overpromising may make you personally liable if the investment fails – and they often do! The sale of equities includes its own set of risks, so be sure you consult with an experienced business attorney before going down this path.

Limited Private Stock Offerings

Most entrepreneurs don't realize they can simply sell stock in their new startup. There are some restrictions, and you should have the advice of your attorney to stay on the safe side. Government agencies such as the Securities and Exchange Commission (the SEC) regulate how stocks are sold. For a small company, this should not be a problem. An exemption from registering an issuance of securities with the SEC probably exists for your small startup. For example, one exemption is for stock sold to those who "take the initiative in founding or organizing the business" – the cofounders. This means you may sell stock to founders. These exemptions come with some restrictions on how much stock you may directly sell, and who you can sell it to.

Here are some of the other restrictions:

- *No more than 35 unaccredited investors (i.e. investors who are not wealthy!)*

- *Investors must be from a pre-existing business, a personal relationship, or a sophisticated investor,*

- *Advertising of the offering is prohibited, and*
- *At the time of purchase, the investor must not intend to resell the securities.*
- *Up to $5M may be raised.*

You will run into the term accredited or qualified investors. These are people wealthy enough that the government doesn't feel the need to protect them. Generally, accredited/qualified investors are people who meet certain criteria, such as having an annual income of at least $200,000 in each of the past two years ($300,000 for joint income) or a net worth of at least $1 million.

Convertible Notes and S.A.F.E.s

Another convenient form of funding a startup is through contracts (instruments) governing what the investment is and how they will get a return for that investment. If you go through traditional means such as incubators, angel funds and the like, they will present a term sheet explaining how they want your deal to operate and often include Convertible Notes and S.A.F.E.S. Here is how they work:

- You get money as a loan. Its debt for the company and usually carries an interest rate. Hence the term "Note."
- When you eventually sell some stock, you pay off the loan off with stock, thus converting the debt to equity at the market price for your stock. Hence the term "Convertible."

The major advantage is that you do not need to value your business, or price your stock, too early in your funding process. Also, the whole process can be done using fairly affordable contracts. You may also hire some professionals in the same manor. For example, they agree to work for you at a dollar amount that is later converted into stock.

They are betting the stock will be more valuable than the amount they would have normally charged you for their services.

S.A.F.E.s and similar tools (such as their close relatives K.I.S.S.es) work essentially the same way, but there are differences in how the note is handled. Investors may prefer one over the other.

Crowdfunding

Recently the US Congress changed the securities laws to make it easier for small investors to participate in funding startups. The crowdfunding model has three parts; you, the people who support the idea, and a crowdfunding organization that brings the parties together to fund the idea. The crowdfunding organization is usually an online marketplace for offering, selling, and trading your stock.

Since a crowdfunding organization is required, the process is set my them. However, before signing on with an online crowdfunding organization some research is needed.

Crowdfunding sites fund a lot of different investments, from startups to baseball cards -- even rare whiskeys. You want to identify sites that offer business opportunities comparable to the type of business you are starting. You are unlikely to have much luck crowdfunding an advance artificial intelligence operating system on a crowdfunding site that specializes in rare collectables. Look into their client base and see what kind of results they get from business such as yours. You can peruse their offerings and see how they operate relatively easily by logging into their sites and looking around.

To participate in crowdfunding, you will need a good story and well-written promotional material. This will often include a video demonstrating how cool your product is. Budget resources for this marketing effort and for paying the crowdfunder, because your results will depend on how good a presentation you make. Expect the crowdfunder to what some up-front money and then to take a percentage of each sale.

Often the crowdfunding site will sell the shares, but act as a trustee of those shares. This way the crowdfunding site becomes a shareholder of your company, but all the individuals are represented by the crowdfunder in trust. Instead of having 1,000 shareholders, you just have one – the crowdfunding organization. This is beneficial because it is easier to manage and minimizes problems with future fundraising efforts. The crowdfunder may also have an “after-sales” market where the investors can buy or sell more shares in your company.

Building a Winning Team

Financing your startup may also be influenced by your team. Investors want to see experience. They are also biased towards younger people in the belief they will put more work into it. You, on the other hand, want a team that can work together, get things done, and not suck the life out of the company.

Before bringing a person into your organization, it is a good idea, to work with them on a small project to see how well you work together. It helps if you do not have competing skills, but rather, have complimentary skills. If you and your new team member are both excellent software developers, who will be responsible for sales? Divide the work based on your skillsets. Most successful startups have a visionary promoting the business and one (or more) other people helping get the work done. They don’t step on each other’s toes either. Let each person do what they do best.

It is often difficult for team members to appreciate the effort of other team members. For example, early in a software project the developer might not think the sales partner is contributing enough. Once the product is launched, however, that feeling may be revered. The selling partner might think the software developer is not doing enough. A winning team will appreciate the contribution of others.

It is important as you build a winning team to thoughtfully exploit each partners skillset. Have clear, defined roles for each team member and measure them on how they perform those roles – not in comparison to other roles.

One common mistake startups make is believing each of the cofounders can go for months without an income. While it looks good on paper, in real life it rarely works out that way. Everyone wants the product out, but plans change, features creep in, and delays happen. Also, life gets in the way; a baby is born or a relative dies. Conventional wisdom is that cofounders will only work for a few months without pay before burnout. They (and their family) worry about money and the success of the venture. If your plans call for free work from cofounders for more than a couple of months, you should rethink your plans.

Employees or Contractors?

At some point you will need to get some help. This is a big step, because having an employee in the United States usually involves a lot of paperwork and additional expenses such as disability insurance. This is why most startups initially take on independent contractors instead of hourly employees. The difference is how they operate and how they pay taxes. An employee works under your rules, whereas an independent contractor works under their own rules. You pay part of your employee's income taxes, whereas a contractor pays all their own income taxes.

Be very careful when you hire contractors and employees so that you don't run into any legal problems. To be an independent contractor that person must be allowed to work independently using their own resources on their own schedule. The Internal Revenue Service has a list of factors that they use to determine whether someone is a contractor or an employee. For the full details see: https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee.

If the IRS determines your worker is an employee, you will be on the hook for their portion of employment taxes and maybe penalties.

Whereas if the person is a truly a contractor, you pay them the fixed rate and they handle their own taxes.

The basic rule is if you hire an independent contractor, you must leave them independent. They use their own judgment, their own tools, work on their own time. Often at their own office. If you direct their time, and their project, and their skills, and their creativity, and their tools, then the more likely it will be for the IRS to say that person is an employee of the company. If that happens you will owe the IRS a big chunk of cash.

Fortunately for us, it is now very easy to onboard an employee. Online payroll services will often handle all the paperwork for you for a small monthly fee. It’s worth exploring these sites because they take a lot of the hassle of the paperwork away from you for a good price. Most importantly, you should have better things to do with your time than paperwork.

In California, like most of the US, workers are governed by very strict wage and hour laws. This means for every four hours they work they must be given an opportunity to take a break. For every workday they must be given an opportunity to have a lunch break. If you fail to follow these laws, you will open yourself up to personal liability. For the details see: https://www.dir.ca.gov/dlse/dlseWagesAndHours.html

While you should consult an employment expert, remember that giving an employee break time, or a lunch break, means you have no control over that time and they’re free to do what they would like. If they are merely grabbing a bite to eat in the car while they’re on their way to your next assignment, they are still working and it is not a legal break. They must be allowed real time off. To protect yourself, track their time accurately.

Use the same standard for early employees as you do for cofounders. Make sure they will work together, get things done, and not suck the life out of the company.

Remember - every employee or contractor must sign over to the company their rights in their intellectual property.

Getting It Built

So, you have some plan on financing your new product, now to get it built. If you can build it yourself, you are in good shape, but often inventors struggle to find a suitable manufacturer or software developer to make their product. There are two major reasons for this. The first is that there is no reliable central database for finding a manufacturer. Identifying a manufacturer with the right resources is difficult – it will require a lot of web searching and phone calls to find people you can work with.

The second issue is the expectations of the startup. The startup always thinks the designer or manufacturer is asking for too much. However, designers and engineers are expensive, and if you need a team of them, then you will need a lot of resources (*i.e.,* money!). Here are some basic rules that will help you when creating a manufacturing relationship.

If you pay to have your product designed, you own all the work product. Make sure your written agreement requires them to give you all the designs and intellectual property. This includes all design drawings, schematics, molds, CAD files and the like. This way, if you have a "falling out" you can take your project to another designer or manufacturer to finish the product development.

If you contract out manufacturing, be sure your agreement says they will only sell the product (and similar products) to you. Yes, we have seen the case where a foreign manufacturer thought that since our client was only selling in the U.S, they could sell the product in other countries. Our client was stunned to find their products for sale in another country where they had little legal protection to help them.

It is not uncommon for a startup to use a local manufacturer for the prototype or earliest production runs, and then switch to a lower cost manufacturer later on. The first production run, or a prototype run will provide you with product that you can use to begin your selling process. It's exciting to get the first product and show it to prospective customers!

Sometimes the manufacturer will fund your development. For example, the manufacturer might agree to design the product for you in exchange for you agreeing to purchase a minimum quantity over the next few years. This works well when you have a manufacturer that is already making products similar to your new product. Since you are committing to purchase products for several years, check your marketing research to make sure you can actually sell that product. (See More Marketing Research on page 41 for a refresher!) It is sad to see a warehouse full of product that nobody wants to buy.

In the long run the best sustainable competitive advantage is lower cost. This way if an aggressive competitor shows up, you can afford a price war, and if your product is any good, you can expect a competitor to show up! Therefore, design for low-cost manufacturing – you will be glad you did. Designers might present many attractive designs, but those designs might price you out of the market. As the entrepreneur it is your job to make those tough decisions about getting the best valued product and still be profitable.

Sales

> *"For every sale you miss because you're too enthusiastic, you will miss a hundred because you're not enthusiastic enough."* ***– Zig Ziglar***

There are no products or service that sell themselves. Your goal is to understand what motivates your customer and respond to that motivation. If you are not comfortable selling, hire someone who is. Eventually sales is the only thing that can make your business a success and it deserves most of your time.

Getting Ready to Sell

Before you can begin selling you must provide tools for your sales team. This usually involves visual sales tools such as brochures or web pages. Customers like big pictures – it helps them quickly understand your product. Your sales team wants clear explanations of the benefits of your product (not just the features!). The marketing material you created for your fundraising can serve double duty!

Marketing is the constant flow of information to your prospective customers on the benefits your product or service provides that no other competitor provides. This flow of information includes word-of-mouth, paid promotion (Google, Facebook, *etc*.), client testimonials, and the like. If you are unsure where to put your marketing efforts, look at what your competitors are doing. If they rely on radio advertising, then maybe you should as well?

Good marketing brings prospects to your website or phone. It must have a “call to action” that invites prospects to act. The results of a marketing campaign are measurable. If you spend $1,000 on Google AdWords, you should be able to quantify the response you got for your $1,000. If you get a lot of responses, but not sales, the problem is probably with your product or service and not your promotion. If you get few responses, then you probably have misplaced your promotional effort. It is okay to experiment with different promotional tools to find the ones that work best for you. The goal of marketing is to make the phone ring. Or at least the order button on your website click!

There are products and service that are low involvement sales. For example, the low-cost items at the checkout stand. It doesn’t take a lot of thought to decide on a pack of gum. An automobile, however, takes a lot more involvement. Customers will do a lot of research and take a lot more time before buying a car. Some products require months or years of work to get the customer to actually make the sale. For example, business customers may need to wait for the next budgeting cycle or require competitive bidding before a purchase order is awarded. Your sales strategy has to appreciate the level of involvement and provide the sales tools, persistence and messaging to get that business.

Selling

One of the easiest ways to sell is to have another do it for you. There are multiple possible “sales channels” you can exploit to grow your business. For example, tools such as Amazon and eBay that provide worldwide visibility for your product. There are also resellers and distributors that have domain expertise – they know how to sell to certain markets. Recently the reach of so-called “influencers” has made them a good means of promotion. Influencers are people, like bloggers and podcasters, with large internet followings. Just like conventional advertising, they provide promotional opportunities, often highly targeted to certain demographics.

There are also early customer and revenue consultants. For example, SKMurphy.com, offers customer development services for startup entrepreneurs. One major advantage of consultants, besides domain experience, is the feedback they provide on your product features and benefits. Do not shy away from negative feedback; it is telling you how to design your next product or service offering. An objective opinion from experienced salesperson may be the most valuable information you have.

The difference between resellers and distributors is a matter of involvement. A reseller acts as your agent. Agents actively sell your product or service in exchange for a sales commission. This is typically 10 to 15 percent. You provide the product or service and any after-sales support. Distributors, on the other hand, perform a lot more. Often, they purchase in bulk, create their own promotional material (with your help of course), and provide follow up service. Distributors want a higher percentage of the sale; expect to pay them between 30 and 40 percent.

If you hope to sell to the “big box” stores like Sam’s Club, Costco and Target, you will most likely need a distributor because big retailers would prefer to work with fewer, more knowledgeable, suppliers. These retailers often demand a lot of their suppliers and if you don’t meet their demands, it might be costly. To be successful as a big box supplier, you should look for an experienced partner to help with the challenges of the marketplace. The major stores all have a place on their web sites for people interested in supplying them with product. Start your search there and follow the directions. For example, Wal-Mart (corporate.walmart.com/suppliers) has explicit instructions on how to sell to them.

One terrific reseller strategy is to be the mustard to the hot dog. This means finding a complimentary product and partnering with the company that provides that product. If your product is a natural add-on to a more expensive product, then you become an easy, low involvement sale. You also help make an easy sale for the partner company too. Think of ear buds for sale with a cell phone, or protective covers for tablet computers. These types of products are an easy sale because they are much lower cost than the main product and don't require much involvement when they are purchased. Plus, the make the overall purchase more valuable.

The Care and Maintenance of Sales People

As the founder of a company, you should be the best salesperson, however, if you are not experienced, then take a few sales classes to learn the art of sales. These are mostly offered by private companies and tend to be industry focused. The Internet is full of information on how to become a great salesperson, but they share a lot in common – they focus on the motivation of the customer. This means understanding the problem they want solved or the desire that your product fulfills. Then, with this understanding, guiding the customer through the educations process to the sale.

Don't make the mistake of thinking salespeople are only motivated by money. Often, good salespeople enjoy the competition to get the sale. They like to win, and money is just a simple way to keep score.

Salespeople tend to focus on short-term results. The work of long-term and near-term results is up to you the entrepreneur. With that in mind, the collective wisdom of several salespeople can still be your most cost-effective research tool. Ask them what features they would like to see and look for commonalities between different markets. Ask them where your industry is headed. They are on the front lines and will provide a fresh perspective.

The Greatest Risk

The major risk of early stage startups is market risk – not legal risk.
- Sean Murphy
SKMurphy.com

Entrepreneurs often spend a considerable amount of time worrying about protecting their IP; however, the greatest risk to a startup is not that someone will steal their idea, but that nobody will buy their product or service. Ponder this for a moment. Without sales your idea has very little value. Spend your time and energy making the most marketable product or service you can.

Ten thousand dollars spent on marketing may take you further than ten thousand dollars spent on patents.

If the market rejects your product, then no amount of IP will help you. Successful entrepreneurs know this and budget their time and resources to make great products that people will pay for. Protecting your IP is just one step along the way towards growing a company.

Finally, remember that a large supply of paying customers solves a lot of business problems. If your product is a huge hit, you will have the resources you need to fix past mistakes. Hopefully this book will set you on the path to avoiding the worst mistakes, and letting you focus on making a huge hit.