Startup Guide to Intellectual Property

Early Stage Protection of IP

By

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

About the Author

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1. IN THE BEGINNING

What is not started will never get finished.
- Johann Wolfgang von Goethe

This is not a law book. It's a *how-to-use-the-law book*. 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.

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.

2. THE BASICS

The beginning is the most important part of the work.

-Plato

No book on intellectual property would be complete without an introduction and this first chapter provides the basics. All four general areas of Intellectual Property are introduced: trademarks (and Logos), trade secrets, patents, and copyright. However, the examples shown are not comprehensive -- that's for later. The examples will, I hope, stimulate you to create valuable intellectual property for your business.

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, 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!"

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

"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. 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

[2] One obscure ancient definition of the word brand is sword.

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, 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.

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 has 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.

If you have a good idea for a company name or trademark, get the Internet domain for it right away. 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

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

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 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 else 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, but 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, in a way, 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

[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!

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 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 costs 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.

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

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. I think we can all think of at least one dominant operating system that's famous for just that; i.e., incorporating other people's ideas into their products.

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 can 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 folks at AstraZeneca 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, for instance. 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.

See also "Should I Patent" on page 66.

3. WORKING WITH ATTORNEYS

There are a couple things about using attorneys that startups need to know, and these apply not just to attorneys, but other 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, before 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

The first mistake start-ups and entrepreneurs make is to assume that their attorney will be an expert on how to run their 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 even on their radar. You job is to learn from your attorney how best to manage the risks you know you're going to take.

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.

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 you can work with, one who knows at least 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.

Manage Your Costs

Another mistake entrepreneurs make is not being proactive in managing their 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.

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 soon, 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.

A Basic Legal Principle

When you are starting your business, there are many possible pitfalls. This book is designed to help you avoid the intellectual property ones. But along the way there are some general legal principles that are helpful in a lot of areas. 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 agreements 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.
- 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.

- 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.

4. PROTECTING IP EARLY

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.

In the Beginning was the Doodle

The proverbial startup originates on a napkin over cocktails or a coffee. Some startups are well planned and highly orchestrated; others just seem to happen. But even the most experienced entrepreneurs often neglect their intellectual property; not that they don't think about it, but they aren't all that clear about who really owns what, and ultimately, how much that what is worth. In business, what you don't know can hurt you, and what you do know can make you rich.

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.

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, every 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.

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 unless you need to.

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 if you can get them.

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 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 company 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 patents, 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 (if you can get them). 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. For a conventional business to be successful, your secret sauce must make you faster, better, or less expensive than the competition. Ideally, you can hit at least two of the three. But 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.

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.

Should I Patent?

Patents are generally the most expensive intellectual property; therefore weigh the costs versus the benefits before spending money on a patent. Don't succumb to the pipe dream -- patents are expensive to get and expensive to enforce. Merely having a patent won't make you rich. As an entrepreneur, you probably have better things to do with your money -- like R&D or marketing.

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 on well-know 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. Can your invention be used in multiple products? 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.

If you are planning on selling your business quickly or taking on investors, patenting may be a good strategy. The public believes patents show that a company is creative and has more value. A large patent portfolio might help you get a better selling price or a better term sheet from investors.

Patents can help sales too. The public likes to see “Patent Pending” on new technology. It gives them confidence in the company.

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. 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.

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 and are not likely to see a return on your patent investment.

Maybe Patent

Most startups are in this maybe category. As a general 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 publically. 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.

If your invention is simply an improvement to an existing product, I'd wait to patent.

Patents last about 17 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.

5. STARTUP OWNERSHIP

Creativity's about ownership

- John Maeda

This book is not intended as a guide to how to best structure your startup. That is best left to your investors and your CPA. 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, lawyers, and CPA can help you decide which is best based on the tax consequences.

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

Startup Agreements

When there is more than one person starting the business, get a startup agreement as soon as you practically can. Remember, 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 in general. They will really 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, <u>get it in writing</u>. Remember, *even the faintest ink is 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 actually 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…

If you have a hard time getting a well-written agreement, consider emails (see *Consider Emails* on page 61).

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.

Funding For Fun and Profit

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. 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. 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. 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 way 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 guy 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.

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, how about if 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.

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 and acquires more the longer they work for the company.

Standard agreements usually start vesting after a year of working for the company.

Investors will usually 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. This could be determined 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.

[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."

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.

6. 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 and is pretty straight forward. Here are some resources if you are inclined to act that way.

Do It Yourself IP

Trade Secrets

Reread the section on Trade Secrets on page 9 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.

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.

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.

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.

7. THE GREATEST RISK

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

This book covers protecting intellectual property during the very early stages of a company's life. 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 best 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, at least with regard to intellectual property, and letting you focus on making a huge hit.