Sponsored by

Morgan Stanley

PricewaterhouseCoopers

Moody's Investors Service

Statistical data supplied by

THOMSON DERWENT

NASDAQ

BANNER & WITCOFF, LTD.
INTELLECTUAL PROPERTY LAW

What venture capitalists expect from your company's intellectual property

This article first appeared in IP Value 2004, Building and enforcing intellectual property value, An international guide for the boardroom. Published by Globe White Page, publishers of Intellectual Asset Management magazine.

iam

William J. Fisher (Washington, DC), Christopher J. Verni, (Boston, MA)

Banner & Witcoff Ltd

United States

What venture capitalists expect from your company's intellectual property

It is no secret that acquiring venture capital financing in today's economy is more difficult than it was during the boom years of the late 1990s. Even though data from the period immediately after Q2 2003 shows the first quarter-over-quarter increase in venture capital disbursements into US based companies in more than three years, one should not be fooled – venture capitalists are still wary (and perhaps even more so) of investing in companies. A company seeking venture capital financing must be aware of what attracts (and repels) venture capitalists and entices them to make the coveted investments.

Venture capitalists do not make their investment motivations a secret. A recent survey of venture capitalists by a law firm on the relative importance of factors that influence a venture capitalist's investment decision revealed that intellectual property followed only management team, market opportunity, and technology. Intellectual property ranked as important as sales and marketing plans, and more important than financial projections and business plan. Intellectual property is important to a venture capitalist's decision to invest even though there are inherent risks associated with IP.

A guide is presented here to identify and address common IP-related, potentially deal-breaking risks before they arise when negotiating with venture capitalists. Upon identifying and addressing such risks, a company will be better equipped to use its IP to make, and not break, a deal.

General IP strategy

From the day it is founded, a company should adopt an aggressive IP strategy that will provide a strong IP portfolio. With an aggressive strategy, a company acquires IP rights with the intent of protecting not only technology developed in-house, but also technology that may be of interest to non-competing companies. For instance, it would be advantageous for an ink-jet printer cartridge manufacturer to foresee that its cartridges could be adapted for chemical synthesis and to have claimed this method before being employed by some drug discovery companies. An aggressive IP strategy seeks to block competitors from the company's present market and potential future

markets. An aggressive strategy also can force a licence, bringing revenue to the company. For these reasons, venture capitalists are attracted to a company having an aggressive IP strategy.

A company needs to be aware of its market and potential markets, as well as non-competing markets, to maximise its ROI from IP. In that regard, a company's IP strategy should constantly be synchronised with its business strategy. Too often, a company changes its business plan to meet ever-changing market demands, but unfortunately neglects to update its IP strategy. One aspect of business strategy relates to whether the company will compete in foreign markets. Because patents are territorially limited, a company should ensure that its IP strategy includes all countries in which the company plans to compete.

An IP strategy is put to the test when a technologically-based company seeks financing because venture capitalists evaluate the strength of a company's patent and trade secret position when deciding whether to invest. In contrast, venture capitalists typically are less interested in a technologically-based company's copyright and trademark position because copyrights and trademarks generally contribute less to a company's revenue than patents and trade secrets. An evaluation of a company's patent and trade secret position provides venture capitalists with answers to their two fundamental questions regarding a technologically-based company's IP:

- Does the company's IP portfolio adequately protect its technology?

- Will the company be infringing third-party rights if it practices its technology?

Patent concerns

A technologically-based company typically chooses to protect its core technology with patents because the term of protection granted by a patent (20 years from its earliest US filing date) generally is adequate in view of the commercial life of the protected products and methods. Also, in certain circumstances, patent term may be extended to compensate for time lost to governmental regulatory review. When considering an investment in a technologically-based company, venture capitalists typically will conduct an evaluation of a company's patent portfolio, the extent of which will depend, in part, on the importance of the patent portfolio to the company's business model.

Where a company's patent portfolio is crucial to its business model (as is often the case with technologically-based companies), the company should be prepared with opinions of counsel. Venture capitalists typically are interested in a due diligence opinion, which also may include invalidity opinions, freedom-to-operate opinions, and non-infringement opinions.

Due diligence opinions investigate ownership, chain of title, product marking practices, maintenance fees, and litigation issues. At a minimum, a company should obtain a due diligence opinion for its most important patents. While due diligence opinions typically are obtained in a merger and acquisition setting, their use is appropriate because, in effect, venture capitalists are making an investment similar to a merger or asset acquisition.

Ownership issues It is axiomatic that a company must establish unequivocal rights to its IP. The most common reasons why a company may not own its patents include:

- Failure of employment contracts. Employment contracts should bind employees to a worldwide assignment, without further compensation, of all right, title and interest to all ideas, inventions and discoveries within the scope of employment. Employment contracts should require employees to give testimony and execute all patent applications, rights of priority, assignments and other documents deemed necessary by the company, and to do all lawful things to enable the company to obtain, maintain, and enforce worldwide protection of such ideas, inventions and discoveries.

- Rights of former employers. Because many companies are founded by former employees of other, typically larger companies, employment contracts of the founders and, if different, inventors named on key patents and applications should be studied. Venture capitalists will be relieved to know that a former employer cannot assert rights in the company's IP and that the company is free to compete in its technology and market areas.

- Rights of universities. Because many companies are based on key technology first developed by university professors or graduate students, agreements between universities and inventors of the key technology should be studied to ensure that a university cannot assert rights in the company's IP.

- Rights of the government. A company funded by government sponsorship should be aware that the government might retain rights in a patented invention resulting from government support. Such rights may include the right of the government to practice the claimed invention or to have others practice it on behalf of the government, all without compensation to the company.

- Rights of collaborators. Because it is common, especially in certain industries (eg, drug discovery and development), for small companies to have collaborations with larger companies, the rights of collaborators to any IP resulting from joint discoveries should be examined. It is important to remember that universities may have collaborator rights to a company's IP as well.

- Rights of co-inventors. In the absence of a contrary agreement, each co-inventor or assignee, to the extent an inventor has assigned his rights, retains the right to practice the invention without compensating the other co-inventors. Venture capitalists will raise a red flag when an unassigned patent naming more than one inventor protects a company's core technology and not all inventors are involved in the company or, worse yet, one of the co-inventors has formed a competing company and assigned rights to that company.

Chain of title issues A company should give particular attention to the chain of title of each of its patents, especially if ownership of the patent has been affected by mergers, acquisitions, reorganisations, corporate name changes, and the like. A company should ensure that its patents (and all IP) have a clear chain of title from the inventor(s) to the desired corporate entity. Security interests that cloud the title of a patent will delay funding.

Product marking A company should be aware that in many countries, failure to mark, ie, label patent-protected goods with patent number(s), will prevent recovery of damages for infringement. When it is impractical to label the product itself, the product packaging should be labeled. Marking goods with Patent Pending is not required, but typically is a good idea because it may allow a company to recover damages for infringing activity occurring earlier in time.

Maintenance fees A company should timely pay patent maintenance fees. Failure to pay maintenance fees causes patents to expire. Likewise, failure to timely pay foreign patent application annuity fees results in their abandonment.

Litigation issues Venture capitalists will certainly inquire as to the existence of any actual or threatened litigation against or contemplated by the company. For litigation against the company, the company should have a non-infringement opinion prepared by competent outside counsel. A non-infringement opinion will consider whether certain products of the company infringe a third-party's patent(s). An opinion of invalidity of a patent asserted against the company also will be of interest to venture capitalists. Venture capitalists will be interested in the competent opinions relating to the validity and enforceability of at least the company's key patents. Such opinions consider the validity and enforceability of a patent in view of both prior art and certain public events, such as prior disclosures, public access, and on-sale activity, each being assessed in accordance with the laws of the country from which the patent issued. For example, whereas the United States affords a grace period after certain public disclosures to file a patent application, other jurisdictions, such as Europe and Japan, have stricter absolute novelty requirements.

Venture capitalists may be particularly interested in a company that has obtained freedom to operate (FTO) opinions from outside counsel. Such opinions provide information related to the company's ability to function in the marketplace in view of the patent rights of others. In particular, FTO opinions should identify others' patents that will block or severely limit the company's ability to market a product or establish a dominant patent position.

It is important to remember that a company should obtain all opinions from unbiased, independent, outside counsel because doing so will only strengthen the credibility of those opinions and, accordingly, will be of greater value to venture capital investors.

Trade secret concerns

Venture capitalists are becoming increasingly aware of the importance of trade secrets to protect a company's technology for which infringement is difficult or impossible to detect and for technology that is difficult to reverse-engineer. For example, a revolutionary process for manufacturing a fungible commodity is a candidate for trade secret protection. It would be impossible for the company to determine infringement by others, and impossible for others to reverse-engineer the process. Under these circumstances, there is little, if any, incentive to publicly disclose the revolutionary process in a patent application as the *quid pro quo* for a limited term of patent protection. Rather, the company may be best served by trade secret protection, which provides potentially infinite protection.

At the same time, venture capitalists are aware that patent protection may be a more prudent form of IP protection because it avoids the unfortunate circumstance of having a competitor independently discover and patent the company's process, which then would prevent the company from practicing the process that it developed first. Perfumes, eg Chanel N°5®, are exemplary products that have proven difficult to reverse-engineer and have flourished under trade secret protection.

A common misperception is that trade secret protection is free, or at least is cheaper than patent protection. However, a company should realise that trade secret protection seldom is free, and in certain instances, costs more than patent protection because of the requirements for maintaining trade secret protection under US and other country's laws. To be afforded trade secret protection, the technology must be information, including a formula, pattern, compilation, program, device, method, technique, or process, that (1) derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Controlling dissemination of information is only becoming more difficult. Besides maintaining more conventional security practices, including providing a secure place of business, implementing a document retention and destruction policy, marking confidential information, overseeing company disclosures in journals and at conferences, and enforcing non-disclosure agreements, a company seeking to protect technology as a trade secret must take additional care, including maintaining the security of its computers and computer network, and limiting disclosure of the secret within the company.

Although an IP management programme attempts to provide protection of trade secrets, risks, such as unintended leaks of confidential information, are ubiquitous. Venture capitalists are aware of such risks, and may be reluctant to invest in a company in which protection of its core technology hinges on trade secret protection.

Minimising risks

A venture capitalist, just like any other businessperson, wants to minimise risk. In that regard, a company should consider further action to make it more attractive to venture capital investors by minimising the risks associated with the investment. To that end, a company may want to acquire the following types of IP-related insurance available from major insurance carriers:

- IP enforcement insurance typically pays a percentage (eg, 80%) of the costs associated with prosecuting an infringement suit including costs incurred in defending any counterclaim; and

- IP defence insurance typically pays the costs associated with defending an infringement suit (but typically not damages if the lawsuit is lost).

IP insurance does not provide perfect protection. Many policies exclude coverage for trade secret misappropriation, which makes the evaluation of third-

party rights discussed above even more crucial. Nevertheless, venture capitalists may be more willing to invest in a company that protects its IP with insurance.

Conclusion

Competently executed, the above guide will help companies avoid common IP-related risks that typically dissuade venture capitalists from making an investment. Armed with safety nets like due diligence opinions prepared by independent outside counsel, a company can increase its odds of obtaining venture capital financing by decreasing the risks associated with IP. Security measures to prevent valuable trade secrets from entering the public domain further decrease risks. By lowering perceived risks, a company can harness its IP to attract venture capital financing.

Author Profiles

William J. Fisher
Shareholder, Washington, DC
Email wfisher@Bannerwitcoff.com

William J. Fisher is a shareholder resident in the firm's Washington, DC office. He earned a BS and an MS in Chemical Engineering from Illinois Institute of Technology, Chicago and a JD from Seton Hall University School of Law, Newark, and he is a regisered patent attorney. He practices a range of intellectual property law, typically in the chemical and mechanical arts. His practice has included client counselling, patent prosecution including interferences, licensing and litigation.

Mr Fisher has particular experience in freedom-to-operate, infringement, validity, patentability opinions and patent preparation and prosecution. He has expertise in organic chemistry, including pharmaceuticals, and inorganic chemistry.

Christopher J. Verni
Associate, Boston
Email cverni@bannerwitcoff.com

Christopher J. Verni is a registered patent attorney who has a broad range of experience in intellectual property matters. He draws upon his industry experience in his practice, which emphasises procuring intellectual property rights for clients in the areas of chemicals, pharmaceuticals and biotechnology and counselling clients regarding their rights.

He graduated with a BS in Chemistry from the University of Rochester and a JD from Franklin Pierce Law Center.

www.bannerwitcoff.com

1001 G Street, NW, Washington, DC 20001-4597
Tel +1 202 824 3000 **Fax** +1 202 824 3001
28 State Street, 28th Floor, Boston, MA 02109-1775
Tel + 1 617 720 9600 **Fax** +1 617 720 9601
Other officess: Chicago IL, Portland. OR