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How to Build and Maximize Value in an IP Portfolio – The Key to Venture Capital Financing

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The following article examines the issues a technology company must address in establishing an IP strategy that will enhance the value of its IP portfolio and its prospects for capital financing. Enhanced value can result, for example, from an increase in revenue and increased market share that results from a well planned IP portfolio. Check lists are provided which can benefit both start-up and more established companies as both need to protect and build the value of IP in core technologies that differentiate their technology from that of their competitors. While this article principally focuses on assisting start-ups to attract venture capital, the process of valuing and building core technology is the same for any size technology company.

I. INTRODUCTION

It is no surprise that the current slowdown in the economy is resulting in a tightening flow of venture capital to fund start-ups. Even in a difficult market, venture capital financing is possible for a company with a strong technology and an experienced management team if the potential market is attractive. The ability of a start-up company to demonstrate market potential to the venture capital community cannot be accomplished, however, without building and constantly nurturing an intellectual property (IP) portfolio. The business plan and IP strategy of a start-up must therefore be planned and coordinated from the outset. Moreover, the IP plan should work in a tandem with a solid funding strategy.

Generally, a venture capitalist (VC) will not invest in a start-up company unless adequate steps have been taken to protect the company's technology and, accordingly, the company's market position or market opportunity. To the VC, IP is often an integral part of value creation in a technology-based enterprise. On the flipside of this equation, founders understandably want to maintain as much ownership of their company as possible. Often, the number one lever available to a founder in this regard is a strong IP portfolio and/or plan.

It is well known that patents, trade secrets, copyrights and trademarks can create advantages needed to establish a dominant market position and to achieve commensurate profits. In turn, this ability to establish a dominant market position translates directly to higher capital stock values and a greater reward for founders and investors. The challenge for a start up is to effectively communicate the potential advantages of what is often nescient IP protection. Often, with a start-up, patents have not been issued, the market and competition have not been wholly identified or proven, meaning the ultimate strength of the IP Portfolio is difficult to assess.

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But it has been proven that a company's IP strategy is likely to determine its future economic success and/or its ability to maintain that success. The recent surge in IP acquisitions and valuations is the only the latest testament to this fact.

But even for a start up, IP offers a differentiation between competitors, or solutions, and therefore it is often the key to quickly achieving significant market share and premium profits – or at least to being able to convey the possibility thereof. Valuable IP can include patented formulas, computer code and technical processes, as well as trade secrets, know-how, trademarks, and domain names. Indeed, a break-through product may derive its success from all such forms of intellectual property.

II. IDENTIFYING AND VALUING INTELLECTUAL PROPERTY

During the dot-com boom, valuations were sky-high and IP was almost an afterthought. Today, however, only companies with solid IP are able to raise money or achieve meaningful valuations. This is because VC's are paying much more attention to IP and are taking much longer to assess their prospective investments. At the heart of such assessments is a full analysis of the IP protection that has been put in place, and whether there is a viable strategy for protecting core technology. As a result, a start-up looking to successfully raise venture capital must be prepared to show that they have put in place IP protection that will justify the valuations they are seeking.

VC's want to gain a thorough understanding of a start-up company's business plan and the competitive landscape it is facing. Then they want to understand how the company intends to achieve its business goals given the competition that exists. They want to know the manner in which a company's IP strategy protects the company's potential markets. They question whether the core technology is protected and whether the company's patents can be used to prevent competitors from using key technology.

In short, it is important to build an IP strategy in a way that is commercially relevant and that allows you to easily convey the commercial relevance of your IP strategy to a potential investor. It is also important for technology start-ups to understand the types of questions a well informed VC will be asking when assessing the start-up.

So what types of questions will a VC be asking? First, the well informed VC will focus on the market, with questions like:

- ☐ What is the market for the company's core technology?
- ☐ Does the technology address significant problems in the market?
- ☐ Does the company's IP strategy lead to a sustainable competitive advantage?
- ☐ Are patents and IP sufficient to create effective barriers to entry of the market by competitors?
- ☐ Is there compelling technical and economic evidence to warrant building a business based on the company's technology?
- ☐ Are there competitive alternatives and, if so, is the market large enough to yield a significant return on the investment?
- ☐ How much capital is needed to achieve a sustainable market position?
- ☐ Are there other potential sources of capital beyond the venture capital?

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Then the well-informed VC will overlay more technical IP issues on the market assessment:

- ☐ How strong are the proprietary aspects of the technology including patent protection?
- ☐ Docs the company have issued patents or patent applications on file with claims that cover the products and services the company intends to market, including anticipated products and services in anticipated markets?
- ☐ Do third-party patents limit the company's freedom to operate?
- ☐ Does the company's IP put it in position to negotiate a favorable cross-license with mature competitors, if necessary?
- ☐ Does the company's IP strategy support its proposed business plans and objectives?
- ☐ Does the company's strategy take into account its competitor's likely course of action?
- ☐ How can the company's IP rights and prospective IP rights be used to enhance the company's valuation prior to a liquidity event?
- ☐ Are there any ownership issues related to the IP?
- ☐ What further development of the technology and the IP position is needed?

A successful start-up must develop its IP strategy with these questions in mind. The more complete the answers, the higher the valuation and/or the greater ownership share the founders will be able to maintain.

III. IP AUDITS

So how does the VC determine the answers to the questions above? Often, a VC will undertake an IP audit. To perform the IP audit, a VC will often hire a diversified and technically sophisticated IP legal team to analyze the IP strategy of a potential investment in the context of the above questions. The following details some of the important aspects of a typical IP audit.

(a) MAKE A LIST OF OWNED TECHNOLOGY

How did the company protect its core technology? List patents, patent applications, trademarks, trademark applications and copyrights. Ensure that the company has established, adhered to Copyright and Trade Secret policies. Create accurate and complete patent, trademark, and copyright files. Search the records of the U.S. Patent and Trademark and Copyright Office and comparable organizations of other jurisdictions, if necessary. Similar searches in other countries would be necessary if the company filed abroad.

(b) DETERMINE SCOPE OF RIGHTS OWNED

(i) Patents

Chart the scope of issued patent claims in view of the market and competition. Determine whether patents have been filed for all patentable inventions of value and whether patent filings have been properly prosecuted. Make sure any renewal fees have been paid.

(ii) Trademarks and Copyrights

Ensure that the company has an established, adhered-to Copyright policy. Ensure applications have been filed for all of the companies' copyrights, trademarks, and service marks. Make sure all fees and renewals are paid and/or filed.

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(iii) Trade Secrets and Proprietary Information

Ensure that the company has an established, adhered-to Trade Secret policy. Look at whether trade secrets are being properly documented and whether the company has taken reasonable steps to protect their confidentiality. Ensure that the company uses confidentiality agreements whenever it discloses its technology to a third party.

(iv) Enforcement

Consider whether the company has been diligent in enforcing its IP rights and whether any potential rights may have been waived or may be the subject of legal or equitable estoppel. Gather all cease and desist type letters. Review all current and potential litigation. Close coordination between litigation and prosecution patent lawyers is the key to success in protecting a start-up's intellectual property and raising capital.

(c) REVIEW IP LICENSES

Review licenses from and to third parties to determine the company's continued ability to use its technology and under what conditions. Assess impact of termination clauses, assignment provisions, fields of use or territory restrictions, royalty provisions, exclusivity terms, and unusual warranties which could significantly affect asset value or transferability.

Employee and consultant agreements need to be reviewed for breadth and enforceability. Beware of "work for hire" doctrine. Is there documentation sufficient to convey to the company usable IP rights in works created by consultants or third parties?

Determine whether the company has licensed or compromised any of its IP, and, if so, how and under what conditions. Review all licenses, assignments, distribution agreements and other commercial contracts that could convey any rights in the IP. Exclusive agreements, which transfer all rights to IP are of special concern. Non-exclusive arrangements should also be reviewed. They may make it impossible to grant exclusive rights in the future and may create unusual royalty provisions or may impose affirmative obligations on the company.

IV. TYPES OF IP WHICH SHOULD BE AUDITED

(a) PATENTS

Patents protect new inventions and grant exclusive rights to make, use, sell or offer for sale the particular product or process claimed. Patents are a significantly stronger form of protection than copyrights. Patents involve higher expenses than copyrights or trademarks. However, the relative benefits justify the expense and trouble seeking patent protection can involve. Patents can be obtained that cover a variety of products and services. Software and methods of business are patentable if they meet the essential requirements for a patent.

There are certain key prerequisites for patentability, including "novelty" and "non-obviousness." These and other prerequisites for patentability involve complex and detailed analysis. A key question to ask: is whether the technology that is the subject of the patent application is in the public domain? Prior to filing your patent application, it is essential that confidentiality and secrecy in relation to your technology be maintained. Failure to keep it confidential can prejudice patentability. Additionally, after a

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patent has issued, proper patent markings should be placed on products or it may be impossible to collect damages in any subsequent infringement suit.

(b) TRADEMARKS

A mark is a word, name, symbol, or device or any combination thereof used to identify and distinguish goods or services and to indicate their source. A mark used on or in the sale of goods is known as a trademark. A mark used in the sale of services is known as a service mark.

Trademark searches, public register searches and domain name searches can be carried out to gauge the strength of current marks owned by the company. If the company chooses a brand or sought trademark protection for a mark which is weak because of others' prior uses, the valuation will often be lower.

Even if trademark protection exists, policing of your trademark rights is important. Has the company moved quickly and decisively to protect its rights? Delays in doing so can prejudice rights in subsequent litigation. Ensure that proper marking and that the registered trademark warning appears on all literature which use the trademark, as well as the correct legal name of the owner.

(c) COPYRIGHTS

In many sectors and particularly in the software field, copyright is perhaps the most utilized form of IP. Copyright prevents the copying of physical material. It is not concerned with the substance of the idea but rather with the reproduction of the form in which the idea is expressed.

Check whether the software developers are employees of your company. If such employees create code or other copyright works during the course of employment, then the copyright in that software is the property of your company. It is different with third party contractors and consultants. If you use them to write software code or create other copyright works, you do not have complete rights unless the appropriate legal documentation is executed.

(d) TRADE SECRET AND CONFIDENTIALITY

First, determine whether a trade secret policy is in place. Have there been proper and enforceable confidentiality and non-compete agreements?

If there were prior disclosures of business secrets, such as ideas for a new product or financial information relating to your business, it is of crucial importance that before the disclosures, the recipient of the information signed a confidentiality agreement or secrecy agreement which provides sufficient protection from unauthorized disclosure or misuse by the recipient.

V. ADVICE FOR THE TECHNOLOGY START-UP

It is important to note that in the venture capital world, turnarounds are much shorter than in typical long-term invested companies. VC's will usually be interested in quarterly evaluations of performance, and will look to get a company up and running and hopefully take it public or sell it quickly.

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VC's look for unique and proprietary technologies that are critical, such as in wireless, software, semiconductor, biotechnology, biomedical and pharmaceutical industries, and that can create new markets which are protected from predatory price competition and price erosion. VC's will want to see that a prospective investment core technology is being protected in a way that is commercially relevant.

So to get the attention of VC's, a start-up should build and maintain a strong proprietary intellectual property portfolio. It is also important to maximize the patent protection of their technology in a way that makes it easier for someone about to invest in their technology to determine whether it is a worthwhile investment. The companies' executives and boards of directors are encouraged to develop a consistent IP strategy intertwined with the business plan of the company.

The IP portfolio should be built by filing broad patent applications early and often to build a fortress around the company's core technology. There must be communication, not only between the IP attorney and the inventors, but also between the IP attorney and management - - including the marketing department and business plan visionaries to ensure that forward-looking patent protection is in place before there is a publication of research findings. A check list for doing so which summarizes both offensive and defensive strategy is attached and summarized below.

This makes the selection of IP counsel a key decision in any start-up's IP strategy. Not every IP attorney understands the business aspect of building a successful IP strategy in today's competitive market. Moreover, not every IP attorney understands the importance of being able to convey the IP strategy in a manner that makes it easy for potential investors to understand. Litigation experience is also important, not only because it helps in writing stronger patents, but navigating a start-up through the critical early phases requires skills in litigation avoidance.

But for the start up flexibility on costs, the ability to offer alternative arrangements, and a thorough understanding of the world of a start up, are also key attributes to look for when selecting IP Counsel. You IP counsel needs to be passionate about your start-up company, really understand your technology and markets, and how to effectively build an IP portfolio for a start-up.

VI. PROTECTING CORE TECHNOLOGY

Whether you are a large company or a start-up, obtaining patent protection is the key feature of any IP strategy. When building an IP strategy, a technology company needs to assess key aspects of its technology and its intended markets. In preparing patents and patent applications, the client and patent lawyer must collaborate to put in place a combination business and IP plan which should start by answering the following questions in Exhibit A.

VII. CONCLUSION

Intellectual capital is recognized as the most important asset of not only many of the world's largest and most powerful companies, but to technology start-ups it is the equivalent of the "equalizer." It is the foundation and the hope for market dominance and continuing profitability. It is often the key objective in mergers and acquisitions. The focus on IP is critically important in today's venture capital market in the United States. A start-up without a solid, readily definable IP strategy is unlikely to be successful in raising venture capital. In contrast, a start-up with a credible, well defined IP strategy can even find itself with some leverage when negotiating venture capital terms.

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Noel Gillespie counsels clients on ways to build and enforce strategic patent portfolios that protect the client's technology and markets so that they can achieve their business objectives. This process includes developing claim strategies that create market barriers and protect or create revenue streams. The process also includes preparation and prosecution of U.S. and foreign Patent Applications. In particular, Mr. Gillespie has extensive experience dealing with telecommunications companies, including companies involved with wireless, wired, and optical communications technology, as well as wireless health, health IT, medical device companies, analytics, and software/Internet companies. He can be reached at noel.gillespie@procopio.com or 619.515.3288.

Exhibit A Intellectual Property Issues — Protecting Core Technology

VIII. OFFENSIVE STRATEGY

a. Review Current Patents And Applications. Determine If Additional Patent Applications Need To Be Filed

i. Coverage Issues - The claims define the technology invented and the boundaries from which competitors will be excluded

1. What do the claims of the patents and applications on file cover? Will they protect sources of income?

2. What type of additional claims can be used, product, process, method composition, broad or narrow?

3. Will they cover the products processes or services you intend to market?

4. Will they cover anticipated products or services in anticipated markets?

5. If we claim methods of doing business – are there flow charts which describe software, hardware and internet implementation of each step in the business method.

6. You can file paper patents even where there is no actual product. Do not be constrained by current technology.

7. Brainstorm – what if you were a competitor trying to avoid the claims? COVER ALTERNATIVES

8. Make your IP plan conform with your business plan.

9. Make sure you own the patents and applications – clear title.

10. In making the above analysis, keep in mind that known prior art must be disclosed to the PTO to avoid a charge of inequitable conduct.

b. Continuously Identify Additional Improvements and Developments to file patents on.

i. Technology evolves, so identify improvements to current products or services.

ii. Identify new products or services – be forward thinking.

iii. Where is the technology going?

iv. What markets should be protected?

v. Identify future markets. Do not be constrained by current technology.

c. Identify Objective Factors Which Support Patentability

i. Was there a long-felt need for the invented technology?

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ii. Was there a skepticism to solving the problems?

iii. Was there a failure of others?

iv. Was there commercial success?

v. Did prior art teach away?

vi. Document the above and use with the Patent Office or with Courts.

d. Establish Formal Mechanisms to Identify and Obtain Patent Protection on New Inventions and Improvements.

i. Engineers, programmers or scientists should keep dated and detailed lab notebooks.

ii. Invention disclosures should be prepared on new inventions.

iii. Schedule regular patent committee reviews.

e. Identify Potentially Adverse Parties having Patent Positions.

i. Who are the major players in each market of interest?

ii. What are their patent positions?

iii. If blocking can they be surrounded?

iv. Can you patent specific commercial uses?

f. Beware of Patent Bar Dates

i. In the United States, there is a one year "grace period" for filing. A patent application must be filed within one year of the first publication, public use, sale or offer for sale or your rights will be lost. Use NDA's whenever possible. We must identify any one year bars!

ii. Outside of the United States, absolute novelty is generally required. In most foreign countries, a patent application must be on file in the United States or other treaty country before any publication, public use, sale or offer for sale.

g. Advantages of Obtaining Patents.

i. Patents are presumed valid and "clear and convincing evidence" is needed to overturn them.

ii. Patents provide the right to exclude competitors who trespass on the property defined in the claims by obtaining injunctive relief in a court of law.

iii. If a patent is infringed, damages can be recovered, including, lost profits or a reasonable royalty.

iv. If the patent is "willfully" infringed, damages can be trebled and attorney's fees and costs can be recovered.

v. Patents may be useful as a bartering tool, as an aid in settling litigation, to raise capital or to avoid litigation.

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h. Foreign Patent Protection.

   i. Applications in foreign countries must be filed within one year of the U.S. filing date in order to retain priority in the U.S. filing date.

   ii. Caution: EPO (European Patent Office), PCT (Patent Cooperation Treaty) and many foreign applications will be published 18 months after filing. These could act as bars to the inventor's other patent applications.

i. Other Avenues of Intellectual Property Protection.

   i. Copyrights

   ii. Trademarks or Service Marks

   iii. Trade Secrets

      1. Confidential disclosures (NDA's)

      2. Employment and Consultant Agreements

IX. DEFENSIVE STRATEGY

a. Identify Potentially Adverse Parties having Patent Protection (I-C above).

b. Patent Clearance and/or Design Around for Products to be Marketed.

c. Attorney Opinions re Competitors' Patents/Applications to Avoid "Willful Infringement."

   i. The legal effects of attorney opinions.

   ii. Evolving stricter standards by Court of Appeals for the Federal Circuit.

d. Financial Risks of Patent Infringement (mirror linage of I-E above).

   i. Costs of litigation.

   ii. Payment of damages (lost profits or reasonable royalty).

   iii. Trebling damages for "willful infringement."

   iv. Injunction (Loss of R&D investment).

   v. Payment of patentee's attorney fees and costs in "exceptional" cases.

e. Possible Risk-Avoidance Strategies.

   i. Indemnity agreements.

   ii. Creating a fund if lawsuit is inevitable.

   iii. Attorney, opinions may avoid "willful infringement" and "exceptional case" if infringing course of action is in good faith reliance on advice of counsel.

   iv. Insurance (both offensive and defensive).

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