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Startup diligence is more than 'basic IP diligence'

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In technology-based startup companies, the strength and integrity of a company's IP portfolio is a key indicator of its enterprise value. Wise investors closely scrutinize the IP of their targets by doing basic IP diligence. But doing only basic diligence can leave investors blind to substantial risks.

Although any IP diligence should include "basic IP diligence" — analysis of a target's freedom-to-operate, IP ownership and patentability — to enable informed decision-making, startups present unique and sometimes hidden risks, which can lurk undetected until a startup matures and gains attention from other market participants. Typically, a startup first realizes these issues when the risks mature in later stages, i.e., when a liquidity event looms large on the horizon.

This article describes hidden risks and offers suggestions for identifying them. For some investments, basic IP diligence may be sufficient. But some startup investments may need additional diligence to identify and measure hidden risks. Knowledge of these risks can further inform investor decision-making and increase investment success rates.

Risks from Prior Employment

Basic IP diligence typically includes analyzing a startup's IP ownership. For example, the startup provides assignment documents from all named inventors to the company. If the assignment documents are legally adequate, then basic diligence is satisfied. But this analysis leaves many questions unanswered.

For example, if a former employer successfully claims ownership, the result can devastate a startup's position. Typically, a startup's IP portfolio includes early-filed patents that provide cornerstones to protect the startup's market positions. These early-filed patents broadly describe the startup's commercial devices, thereby providing valuable blocking positions to prevent others from encroaching on its customer base. Losing such a patent provides a double hit to a startup's position: it not only weakens the startup's market share defense, but the loss may also give a competitor the tools to prevent the startup from reaching its target customers.

To analyze the risk of former employer IP ownership, an investor can ask the startup for an invention timeline. The investor can also ask for employment agreements between each inventor and his/ her former employer. If a former employer can claim ownership over the IP, an investor needs more detailed information on the invention timing and circumstances for an accurate risk picture. The IP team can apply the same analysis to the startup's licensed-in IP.

Risks from Contractors, Consultants and Former Employees

For some startups, early development necessitates contractors and consultants. In addition, some startups may lose original employee inventors due to early stage financing struggles. These early relationships can affect IP ownership.

As described above, basic IP diligence looks at the inventors listed on each patent or patent application and answers whether legally adequate assignment documents exist for each inventor. But there is a risk that the startup did not name an inventor(s) on the patent. Non-named inventors can include contractors, consultants, and former employees who worked with the startup during its early stages.

The relevant question is whether non-named inventors must assign their IP rights to the startup. The answer to this question turns on the wording in the applicable contract agreement, consultant agreement, or employment agreement. If a non-named inventor is not legally-obliged to assign an invention to the startup, then that omitted inventor enjoys co-ownership of the patent or patent application. Co-ownership significantly, if not fatally, weakens a startup's IP position because co-ownership erodes the startup's control over its own IP (e.g., a co-owner can license the IP to a competitor).

To reduce surprise ownership risks, an investor's IP team should examine the circumstances (including any contracts) behind the startup's early development for evidence of contractors, consultants, or former employers who might legitimately claim joint inventorship of the startup's IP. As with prior employment risk, the IP team can apply the same analysis to the startup's licensed-in IP.

Risks from Existing Market Participants

Existing market participants present a particularly important hidden risk source. Basic IP diligence includes a freedom-to-operate (FTO) analysis which typically examines whether third-party patents present an infringement risk to a startup. But basic diligence FTOs may overlook significant risk, even if an FTO analysis finds a low infringement risk. For example, even though an FTO analysis finds a low infringement risk: (1) a market participant may still pursue patent litigation against a startup in an effort to distract the startup and derail growth, (2) market participants may leverage existing patent applications to tailor future patents specifically to the startup's commercial products, or (3) some market participant's patent assets may remain hidden until later in a startup's lifecycle.

If sued, patent litigation costs can bury a startup. Even if a startup can settle litigation, settlement terms can change the startup's value. Investors can factor litigation risk into diligence by examining who owns market share in the startup's field. A first question to ask is which market participants stand to lose market share through the startup's growth and how much? If a market participant stands to lose a significant market share, then that market participant may seek to protect its market share by filing a lawsuit (even with a weak charge of patent infringement).

An investor can further refine the market participant list by the litigiousness (past, present, or anticipated IP disputes) of those participants and their IP portfolios; litigiousness indicates a market participant's propensity to pull the litigation trigger, and IP portfolios demonstrate how much value the market participants place on their IP portfolio (another indication of a market participant's propensity to wield that portfolio). An investor can combine these three factors (market share, litigiousness, and IP portfolio) to develop a picture of future litigation risk. Note that none of this risk turns on whether the market participant's portfolio actually covers the startup's product.

Conclusion

To evaluate startup investment risk, an investor must first analyze basic IP diligence factors (freedom-to-operate, patentability, and ownership). But basic diligence can leave some important questions unanswered in startup investment, thereby concealing significant risks from investor decision making. Identifying and evaluating as many risk factors as possible increases startup investment success rates. As described above, a little extra diligence can go a long way to clarifying startup IP risks.


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