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INITIAL CONSULTATION™ SERIES

Initial Consultation for Entrepreneurs

A Business Law and Intellectual Property Law
Guide for Start-Ups and Small Businesses

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Introduction

The purpose of this legal guide is to provide you, as an entrepreneur, with a general overview of the legal issues you should be aware of when starting, managing, and growing your business. This guide is designed to be a starting point for your continued research into how best to structure and protect your business; the guide will hopefully also serve as a handy desk reference for the legal basics.

There are two main sections to this guide. The first section deals with the various business entities, including their organization and structure, how they are taxed, and general information on their formation. The second section deals with the various ways to protect your intellectual property, including trademarks, copyrights, patents, and trade secrets. The guide concludes with some general information regarding employment law, business financing, and insurance. Where applicable, this guide attempts to tie general concepts to new and emerging issues in Internet and E-commerce law.

Unlike other guides or how-to books for entrepreneurs, this guide will not attempt to educate you on how to be an entrepreneur. You already know your skill set and have developed expertise in what you do. Because this guide is intended for any entrepreneur starting a business anywhere in the United States, many of the legal principles and rules will be generalized. This is of necessity as state law can vary greatly. That being said, the guide endeavors to provide you with substantive legal information that will be of use to you now, as well as point you in the right direction for continued research.

As already stated in the terms of use you had to agree to in order to purchase this guide, ***the information in this guide does not constitute legal advice.*** You should not make any decisions that affect you or your business based on the information contained in this guide. The information in this guide is generalized, and cannot substitute for actual legal advice regarding your particular situation. ***Nor does this guide create an attorney/client relationship between you and the author.*** As the law is constantly in flux, you must also be aware that information that was accurate at the time of this writing may become inaccurate by the time you read the guide. For that reason, the author can make no promises or guarantees regarding the accuracy of the information contained herein.

It is of critical importance that you consult with a licensed attorney before making any decisions or undertaking any actions. This guide is simply an attempt to give you “a lay of the land.” It is intended to save you time so that when you meet with your attorney, you will already have a general understanding of the legal issues at stake.

To put it in non-legalese: this guide is intended as a helpful *starting point* that is merely an educational tool, so, for the love of everything that is holy, do not go making any decisions or undertaking any actions based on the information contained in this guide.

Section 1: Business Entities

The purpose of this section is to provide you with a general overview of the most commonly-used business entities. These entities include sole proprietorships, corporations (both C and S), general partnerships, limited partnerships, limited liability partnerships (“LLP’s”), limited liability limited partnerships (“LLLP’s”), limited liability companies (“LLC’s”), and joint ventures and strategic alliances.

This guide will treat each business entity in turn, discussing their general characteristics, including how each is structured, managed, and owned. The guide will give you some tax issues to consider and will provide a general guideline for how to form each entity. The guide takes no position on whether any given entity is better than another. The choice of what business entity is right for you depends on many factors: general characteristics of the entity itself, your unique business model, your risk tolerance, the source and amount of financing, your business goals, the number of people involved, each person’s given skill sets, and the particular state in which you will be “setting up shop.”

Each state has its own laws regarding what entities are allowed, how they are structured, how they are formed, and how they are taxed. That being said, many states have similar statutory schemes because of the push to adopt uniform laws. This guide cannot capture every state’s law. The purpose of this chapter is to serve as a mere starting point for continued research into what business entity is right for you.

Sole Proprietorships

Organization and Structure

A sole proprietorship comes into existence when a single individual begins running his or her own business. A sole proprietor can hire employees or independent contractors, but the sole proprietor is the only owner. If a sole proprietor takes on another owner—or vests someone else with enough responsibility to make them a *de facto* owner—the law will treat that business entity as a partnership.

The benefits of a sole proprietorship are that it is often the simplest, quickest, and cheapest business entity to form and manage. As a sole proprietor, sole management authority rests in you as the business owner. Depending on your personality and risk tolerance, this characteristic can either be a benefit or a drawback.

With sole ownership and management responsibility comes personal liability. This is the most important point about sole proprietorships: a sole proprietor is personally liable for all of the debts and obligations of the business. In other words, if you were subject to a judgment from a lawsuit that exceeded the amount of capital you had contributed to your business plus any accumulated revenue, the defendants could go after your personal assets to satisfy the judgment.

Taxation

Federal and state income tax authorities consider a sole proprietorship to be a “disregarded entity,” and treat all income and expenses of the business to be the owner’s personal income and expenses. A sole proprietor must also pay the federal “self employment tax,” which is currently assessed around fifteen percent (15%) of net earnings. *See generally* <http://www.irs.gov/businesses/small/article/0,,id=98846,00.html> (IRS website regarding the self employment tax).

A sole proprietor who hires employees will have to pay all relevant taxes and withholdings associated with employment. A sole proprietor will also have to pay other miscellaneous state taxes, such as sales tax and the like. A sole proprietorship is no different than any other business entity in this regard.

Formation

There are generally no state or federal registration requirements for forming a sole proprietorship. The most important, and sometimes only, step in forming a sole proprietorship is obtaining a business license from your municipal or local governmental authority. Prior to engaging in any business, however, be sure that you obtain any and all necessary licenses, permits, or exemptions. For instance, you may need a use permit or exemption if you plan on running your business out of your home as there are often zoning restrictions in residential neighborhoods that limit or prohibit business operations.

If you intend on using a business name that is different from your personal name, then you will likely have to file a “fictitious business name statement” or a “doing business as” with your municipal or local governmental authority, and then publish your “d.b.a.” in the local newspaper for a required period of time.

If you do not hire employees, then your Social Security Number will double as the business’s tax identification number. If, however, do you hire any employees, you will need to obtain a federal employer identification number (“FEIN”) by filling out and filing IRS Form SS-4 (<http://www.irs.gov/pub/irs-pdf/fss4.pdf>). In fact, all business entities, except for the sole proprietorship without any employees, must obtain a FEIN.

Summary

Sole proprietorships offer an entrepreneur the opportunity to form a business entity quickly, easily, and cheaply. An entrepreneur must be mindful that in operating as a sole proprietor, however, his or her personal assets will be exposed to the business’s creditors.

Corporations

Organization and Structure

A corporation is arguably the most complicated of all the business entities to form and operate. A corporation is essentially a business entity whereby ownership and management, at least theoretically, are separated from one another. To understand how this is accomplished, we have to look at the key players involved: incorporators, directors, officers, and shareholders.

Incorporators bring the corporate entity into existence. They do so by filing Articles of Incorporation. The incorporators will also adopt the bylaws and select those individuals who will serve on the board of directors. The directors of a corporation set broad corporate policy and manage the overall direction and “big picture” aspects of a corporation. The directors, at their first board meeting, will select officers—like the president or chief executive officer (“CEO”)—who will be in charge of managing the daily operations of the corporation. At this first board meeting, the directors will also issue “equity” or ownership interests in the corporation, known as shares of stock, to the shareholders.

Although the incorporators select the first directors, the shareholders thereafter will have the sole responsibility of voting on who will serve on the board. A share of stock gives a shareholder not only an economic interest in the corporation, but also ordinarily gives the shareholder certain rights. One common right is the ability to vote for directors. A corporation can create different types or “classes” of stock, each with its own package of rights and powers. For example, some shares may have limited or no voting rights, or some may give certain shareholders priority over other shareholders upon liquidation.

The shareholders are the owners of the corporation, but do not manage the corporation. Directors and officers, by contrast, do manage the corporation, but have no ownership interest in it. Because the shareholders/owners of a corporation are not responsible for its management and operation, the law relieves them of personal liability. Unlike a sole proprietor, an owner of a corporation will not be held personally liable for the entity’s debts or obligations. The most “out of pocket” loss a shareholder can experience is simply the amount of capital contributed to purchase the stock. Corporate directors and officers also enjoy varying degrees of limited liability protection.

The split between ownership and management can become blurred, however, because directors and officers can be, and often are, shareholders. For example, many large corporations incentivize and compensate their officers with valuable stock options. Or, consider the “mom and pop” corporation that has only two individuals, both of whom are the only directors, officers, and shareholders. In order to preserve the corporate entity form—and all of its rights and benefits—the law requires strict observance of procedural formalities. For instance, most states require a corporation’s board of directors to hold and document yearly meetings. Failure to observe such corporate formalities can expose the shareholders to liability, as discussed below. Please note that some states allow smaller corporations to relax corporate formalities, yet

preserve the limited liability benefits, if the corporation qualifies as a “close corporation.” *See, e.g.,* California Corporations Code § 158.

Courts have the ability to disregard the corporate entity form, and thereby hold shareholders, officers, and/or directors personally liable for the corporation’s debts or obligations. This is what is meant by the term “piercing the corporate veil.” Courts will pierce the veil when it has been proven that the corporate entity is a “shell” or “personal holding company” for the shareholders. The idea is that if the corporation is just the “alter ego” of the shareholders, then it makes sense to use both corporate assets and the shareholders’ personal assets to satisfy any judgments against the corporation. Observing corporate formalities can serve as evidence that the corporation is not an “alter ego” of the shareholders.

As a shareholder, officer, or director, you can also be held personally liable if you personally guarantee a debt of the corporation. In large corporations this is less of a concern. It would have been surprising, to say the least, if Bill Gates were to have personally guaranteed a billion dollar contract for Microsoft. With smaller and newer corporations, however, banks or other investors may require a personal guarantee in order to loan money or enter into a contract. These investors want the reassurance that if this fledgling corporation goes under, there is still someone who is obligated to perform. If this is a situation in which you find yourself, just remember that the corporate form will not protect your personal assets if things fall apart.

The law imposes fiduciary duties of care, loyalty, and good faith and fair dealing on directors, officers, and, sometimes, majority shareholders. The duty of care is the obligation that officers manage the company reasonably and with sound judgment. Most states have a presumption that officers exercise reasonable care in their management responsibilities. This is known as the “business judgment rule.” The duty of loyalty is the obligation that officers avoid conflicts of interest and put the interests of the corporation ahead of their own personal interests. For instance, an officer breaches the duty of loyalty when that officer engages in “self dealing.” Self dealing occurs when an officer “usurps a corporate opportunity” or otherwise takes advantage of his or her position as a fiduciary or an “insider” to advance his or her own interests at the expense of the company. The duty of good faith and fair dealing is as it sounds: simply a duty to acquit one’s duties and responsibilities fairly and in the best interests of all parties.

Although corporate bylaws usually allow for some form of indemnification of directors and officers in the event of a suit, a director or officer can still be held personally liable if that individual breached a fiduciary duty. There is no uniformity across the states for what constitutes a “bad act” that will violate these duties. As discussed below, many large corporations favor incorporating in Delaware because of more lenient corporate law regarding corporate governance and director and officer liability. In other words, an act that might violate the duty of care in California might not violate the duty of care in Delaware.

For continued research, visiting the Secretary of State website for the state in which you wish to incorporate can be useful. Although it can be dense, reviewing the relevant sections of

your state's corporate code can also be informative. These statutes can easily be found by using a search engine.

Securities

Understanding securities regulations is necessary when forming a corporation because a share of corporate stock is a “security.” A security is an ownership interest in a company or venture over which you have no control or management authority. Both state and federal securities laws govern the sale and management of securities. These laws cumulatively prohibit a corporation from selling or offering to sell any security without first registering with 1) the relevant authority of the state in which you have incorporated, 2) the federal Securities and Exchange Commission (“SEC”), and 3) any other state in which a given purchaser of the stock resides (this is what is meant by “blue sky laws”).

The purpose of these registration requirements is somewhat paternalistic. The relevant governmental authorities want to protect those individuals who have an ownership interest in a given enterprise, but have limited power over or knowledge of how that enterprise is managed. Registration or “qualification” can be quite cumbersome. Both state and federal law, however, recognize several exemptions from the registration requirements. The idea behind one of the most commonly-used exemptions is that if the offering is small enough, and given to savvy investors or people with whom the issuer has a pre-existing relationship, then there is less of a need for paternalistic protection.

Regardless of whether your offering would be covered by state and federal exemptions, it is imperative that you make sure your offering fully complies with all applicable securities regulations. Federal law is largely governed by the Securities Act of 1933, which can be found starting at 15 USC § 77a. Because these laws can be quite complicated, you should consult a business law attorney.

Taxation

A detailed discussion of corporate tax law is beyond the scope of this guide. Furthermore, hiring an accountant prior to incorporating is one of the soundest investments an entrepreneur can make. Spending some money early to utilize a professional trained in tax planning can save you and your company a significant amount of time and money. It is always cheaper to plan around problems before they emerge rather than attempt to fix them after they have grown.

The most important fact to remember about corporate taxation is that a “C” corporation—which is an ordinary corporation—is subject to “double taxation.” This is considered the biggest drawback to the corporate entity form. Double taxation means that 1) the corporation must pay taxes on the net income of the corporation, and 2) the shareholders must pay taxes on any dividends paid out. If you are thinking you can avoid double taxation by simply holding dividends in the corporation, the Internal Revenue Service (“IRS”) already thought of that one

and will force a corporation to pay an “accumulated earnings tax” if the corporation retains earnings in excess of what the corporation needs. One of the most common ways to avoid double taxation is to register with the IRS as an “S” corporation.

To form an S corporation, you form a regular C corporation (as discussed below), but then make an election with the IRS that turns the corporation into a “flow-through entity” for income tax purposes. This means that no income tax is paid at the corporate level, but the individual shareholders are taxed at their individual level in proportion to their stock ownership. Please be aware that this means the shareholders are taxed regardless of whether a dividend or distribution is made, unlike a C corporation where the shareholders are taxed only when the dividend or distribution is made.

The general requirements for an S corporation are: 1) the corporation have no more than one hundred (100) shareholders; 2) only U.S. residents, certain tax exempt organizations, or qualified trusts can be shareholders; and 3) there is only one class of stock (notwithstanding differing voting rights). See IRC § 1361. The necessary filing for S corporation status is IRS Form 2553. See <http://www.irs.gov/pub/irs-pdf/i2553.pdf> (IRS website regarding instructions on filing); <http://www.irs.gov/pub/irs-pdf/f2553.pdf> (Form 2553). You should always consult an attorney and an accountant before making an S corporation election.

Some remaining important tax issues to consider concern the contribution of capital (in the form of money, property, and/or services) to the corporation. For further research on these issues, consult Internal Revenue Code (“IRC”) §§ 61, 351, and 721 as a starting place.

Please note that neither a corporation nor its officers have to pay the federal self employment tax. Some states, like California, will require corporations to pay an annual franchise tax.

Formation

As discussed above, the procedure for forming a corporation can be boiled down to four steps: 1) preparing and filing the Articles of Incorporation; 2) adopting bylaws at the meeting of incorporators; 3) selecting directors at the meeting of incorporators; and 4) holding the first board meeting whereby officers are appointed and shares of stock are issued to shareholders. Although this is incredibly simplified, it hopefully gives you a general idea of how the process works. What follows in this section will be a brief discussion of possible pre-incorporation acts, the Articles of Incorporation, and the bylaws.

Although not always necessary, you may consider entering into a pre-incorporation agreement with the other potential shareholders regarding number of shares each will have and how much each will pay. Such “subscription” agreements need not even be in writing, but it is always advisable to have any business dealing or contract memorialized in writing. You may also need to enter into various contracts prior to incorporating. For instance, you may need to enter into a lease agreement to rent space for your business, or maybe you will need an

equipment lease. Please remember that prior to incorporating, you are entering into these agreements on your personal behalf, and not as an agent of the corporation. This means that you will be held personally liable to these contracts. To prevent continuing personal liability, consider negotiating for a clause that provides for the assignment of your responsibilities to the corporation once it has been formed.

The filing of the Articles of Incorporation with the relevant Secretary of State is what officially brings the corporation into existence. There is no standardized form for the Articles because they can differ so widely. That being said, there are a few sections that are ordinarily required:

- 1) The name of the corporation;
- 2) A statement of the corporation's purpose;
- 3) Information regarding the number of shares and the different types of shares, including the rights and restrictions placed on each type of share;
- 4) The full name and address of agent for service of process; and
- 5) The signatures of the incorporators.

The Articles can, and usually do, include any number of optional sections. Please consult with an attorney regarding what to include in the Articles, and whether such optional sections should be included in the Articles or in the bylaws. If you believe that you may want to amend some of these sections later, keep in mind that it is generally easier to change provisions that are embodied in the bylaws only. Otherwise, you have to go through the rigmarole of filing Amended Articles of Incorporation.

Please keep in mind that many provisions in a state's corporate code are considered "default" rules that will apply in the absence of language to the contrary in the Articles or the bylaws. There are other statutory laws, however, that cannot be changed by private agreement. For instance, neither the Articles nor the bylaws can absolve an officer of his or her fiduciary duties. Any provision in the Articles or the bylaws attempting to change an invariable rule of law will be held invalid. Please consult an attorney to determine which laws are variable and which laws are invariable.

After the Articles have been approved by the Secretary of State, the incorporators will draft and approve the corporate bylaws, which embody the rules, regulations, and procedures that govern the management and operation of the corporation. The bylaws are often far more robust than the Articles. The Articles simply bring the entity into existence; whereas, the bylaws give the corporation purpose, form, and structure.

Both the Articles and the bylaws must be drafted in a way that is consistent with invariable state law as well as with one another, and any pre-incorporation or shareholder “buy-sell” agreements (discussed below) that have been entered into.

Because bylaws are incredibly unique and specific to each corporation, please consult an attorney regarding what should be included in your bylaws. Some of the more common sections in bylaws include: 1) restrictions on the right to transfer shares; 2) procedures for management of the corporation; 3) the availability of and procedures for procuring proxies (a “proxy” is when one shareholder grants to another shareholder the right to exercise that first shareholder’s voting rights); 4) the rights, powers, and restrictions embodied in the different classes of stock; 5) information regarding the board of directors, such as the number of directors, how they are elected, and their term of office; and 6) rules regarding the amendment of the bylaws.

In addition to having provisions in the bylaws regarding shareholder’s rights vis-à-vis the ownership of shares, it is usually advisable for shareholders to enter into a shareholder buy-sell agreement. These agreements can take many forms and vary widely, but they essentially give existing shareholders a “right of first refusal” to purchase shares if another shareholder sells his or her shares or dies, or if the corporation decides to issue more shares. These agreements help existing shareholders preserve their interest in the corporation in the face of possible dilution. They can be incredibly helpful in establishing the price, or the formula for determining the price, of the shares to be purchased.

Choosing the State of Incorporation

The state in which you incorporate your business does not have to be the same state in which you have your principal place of business or where you conduct the majority of your business dealings. Many corporations will cherry-pick certain “foreign” states in which to incorporate because of more favorable tax or corporate governance laws. Nevada is a popular state because it has no corporate income tax, no franchise tax, no personal income tax, and pro-business governance laws. See http://sos.state.nv.us/business/comm_rec/whyinc.asp (Nevada Secretary of State’s website discussing the advantages of incorporating in Nevada). Delaware is also highly popular because of its similarly favorable tax laws, but also because of its exceedingly liberal pro-business governance laws. See http://corp.delaware.gov/whycorporations_web.pdf (publication by Delaware Department of State Division of Corporations discussing the advantages of incorporating in Delaware).

Regardless of the state in which you incorporate, you must certify your business as a “foreign corporation” in any other state in which you do business. As a foreign corporation, your business will be subject to some, but usually not all, of the corporate laws of that state. This means that your business can lose some of the benefits of incorporating in Nevada or Delaware if it does business outside of those states. For instance, California applies its franchise tax to all corporations that conduct business in California, whether the corporation is foreign or domestic. If you incorporated in Nevada, yet transact most of your business in California, you must still

pay a franchise tax even though you might have sought to avoid this tax by incorporating in Nevada.

California also has another tricky bit of corporate law called the “quasi-California corporation.” See California Corporate Code § 2115. This law provides that if a foreign corporation does most of its business in California, then that corporation will be subject to even more California laws than will other foreign corporations. This can often vitiate the benefit of incorporating in either Nevada or Delaware.

None of this is to say that you should not consider incorporating in a foreign state. Instead, highlighting these issues is just a springboard for your continued research. As always, you should consult an attorney to weigh the costs and benefits of where to incorporate.

Summary

A corporation offers an entrepreneur a limited liability entity that is also highly adaptable to the entrepreneur’s particular circumstances. Think of the corporate form as an “off the rack” suit that is easily tailored to fit your goals and needs. The corporate form can be highly attractive for investors because of this easy malleability. Please keep in mind, however, that corporations can be expensive and time consuming to form and to operate. Furthermore, unless you make an S corporation election, you will be subject to double taxation. With these burdens, however, comes the benefits of limited liability, well developed statutory and case law, and a business entity that will fluidly evolve as you grow your business.

General Partnerships

Organization and Structure

A general partnership is an association of two or more parties who jointly own and operate a business. A general partnership is a separate entity from any of the individual owners. All partners, however, are “jointly and severally” personally liable for the debts and obligations of the partnership business entity. “Joint liability” means that each partner is liable for the full amount of the debt or obligation. “Several liability” means that a given partner is fully liable for any debt or obligation that that partner personally guaranteed. Combined, “joint and several liability” means a creditor can satisfy the full amount of a partnership obligation from any partner’s personal assets, regardless of which partner made the guarantee. If the creditor recovers a full judgment from only one partner, the onus is then on that partner to seek any reimbursement from the other partners.

When forming a general partnership, you should consider the relationship of the owners to the business itself, as well as the relationship of the owners to each other. In a sole proprietorship, the sole proprietor may hire an employee who is given the authority to enter into contracts on behalf of the business. This is an agency relationship whereby the employee is the

agent and the sole proprietor is the principal. The agent can bind the sole proprietorship to an obligation, but the sole proprietor has the right to revoke the agent's authority at any time.

In a partnership, by contrast, the partners' relationship to each other is not that of an agent and a principal. Rather, the partners are not agents of each other, but are agents of the business entity itself. As an agent for the business, each owner is capable of binding the partnership and, therefore, the other owners. Revoking the authority of a partner to bind the partnership is far more difficult than revoking the authority of a mere employee. Because of this power to bind all parties, you should give serious consideration to whether you trust your potential partners and have faith in their business judgment and management abilities.

The laws of the various states impose the fiduciary duties of care, loyalty, and good faith and fair dealing on each of the partners. The way courts will enforce these fiduciary duties can be fairly wide-reaching. For instance, if you are engaged in a business deal that does not involve the partnership or your partners, but could potentially negatively impact them, you could be held liable for a breach of a fiduciary duty.

Although each state has its own set of laws governing general partnerships, many states have codified the Revised Uniform Partnership Act of 1997, which was drafted by the National Conference of Commissioners on Uniform State Laws ("NCCUSL"). *See* <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.pdf> (PDF copy of the Act); *see also* California Corporate Code §§ 16100–16962 (California's codification of the Act).

As with corporate law, state partnership law has many "default" laws that can be varied by private parties. Like corporate law, however, there are invariable partnership laws as well. For instance, partners cannot "contract around" the fiduciary duties that they owe to each other. Although statutory law provides a solid background, the partnership agreement will usually govern the majority of a partnership's operations. Although there are no laws requiring a partnership agreement to be in writing, it is exceedingly important that it be put into writing.

General partnerships can be a good business entity option where you have a significant amount of trust in your potential partners and know that all parties will contribute equally. It is usually a more attractive option if all partners will be involved in the management of the business, particularly because the decision of one partner affects the other partners. Passive investors, who want an equity interest, but have no role in management, will be more inclined to select a business entity that provides some limitation on personal liability.

Taxation

Income tax authorities treat partnerships as a "flow-through entity," meaning that the partnership entity must file its own tax return and declare its net income, but the partnership entity itself pays no taxes. Instead, the tax burden "flows through" to the partners, who will be taxed on the allocable share of net income. Unlike a sole proprietorship, the partnership is not

“disregarded” for income tax purposes, as it must file its own return even though it pays no taxes.

Unlike a corporation, partners are taxed on their allocable share of net income regardless of whether any distributions of income are made to the partners. Recall that shareholders are taxed only when dividends are paid out.

Please be aware that the federal self employment tax applies to all general partners.

Tax Differences between General Partnerships and S Corporations

Understanding the differences between a general partnership and an S corporation and for income tax purposes is essential when making *any* entity choice decision. This is because federal and state income tax laws allow most business entities to make an election between being taxed 1) as a C corporation (which is uncommon because of double taxation) or 2) as a general partnership (which is far more common because of the flow-through taxation). Limited partnerships, limited liability partnerships, limited liability limited partnerships, and limited liability companies are all given the choice of electing between C corporation taxation and general partnership taxation. Such an election is usually perfunctory because it is almost always in a business’s best interests to elect the flow-through general partnership tax treatment.

Because LLC’s have limited liability for *all* of their “members” and are ordinarily pass-through tax entities, they are seen as analogous to S corporations, which also have both of these attributes. For this reason, a number of entrepreneurs will narrow their entity choice decision down to either an LLC or an S corporation. This begs the obvious question of what then are the differences between an S corporation and an LLC.

In terms of liability, the difference between the two is negligible, at least for purposes of an introductory discussion. The real crux of the decision turns then on what is the difference in income tax treatment between a general partnership (which an LLC would be taxed as) and an S corporation.

What follows is a list of the primary income tax differences between a general partnership and an S corporation:

1) Allocations: In an S corporation, shareholders are taxed exactly in proportion to their percentage of ownership in the corporation. In a general partnership, the owners can allocate their tax burdens among themselves; they are not forced to pay tax strictly on their percentage of ownership.

2) Basis Adjustments: In an S corporation, a shareholder’s tax basis will not be adjusted when the corporation incurs debt. Furthermore, shareholders in an S corporation are not allowed to adjust their basis at the death of a shareholder; whereas, general partners may make such an adjustment of basis pursuant to IRC 754.

3) Contribution of Property: In an S corporation, a shareholder's contribution of appreciated property, or the distribution of appreciated property from the corporation to the shareholder, is a gain to the shareholder. The distribution of depreciated property from the corporation to the shareholder is not a loss to the shareholder. In a general partnership, a partner's contribution of property to the partnership is not a taxable event. A distribution of appreciated or depreciated property from the partnership to a partner is neither a gain nor a loss, respectively.

Finally, as already discussed, general partnerships are subject to the federal self employment tax; whereas, S corporations are not.

Formation

A general partnership is formed when the partners enter into a partnership agreement. A partnership can file a certificate with the Secretary of State, but this is not usually required. Please also consult your state's law regarding whether you must file a d.b.a. statement.

As stated above, the partnership does not legally need to be in writing. That being said, it is always advisable to put the agreement into writing. Doing so records the terms of the agreement in tangible form, and also helps the parties to consider critically all of the relevant issues. There is something about putting ideas and concepts into writing that makes one think more fully and clearly about the issues at stake.

You should consult an attorney to fine-tune the contents of your partnership agreement. Although each agreement is different, some common sections include: 1) the purpose of the partnership; 2) how and by whom the partnership will be funded; 3) how and to whom distributions will be made, 4) how the partnership will be managed and by whom; 5) the conditions under which a partner may withdraw; 6) any accounting or record keeping information, including accounting methods and the fiscal year; and 7) how and under what circumstances the partnership will be dissolved.

Summary

General partnerships offer entrepreneurs a business entity that is relatively easy to form and operate, and carries with it certain tax benefits. A general partnership works well when all parties plan on actively managing the business and already have a significant amount of trust and respect for one another. This is because any partner may bind another partner to any partnership obligation.

Limited Partnerships

Organization and Structure

A limited partnership is an association of two or more parties with at least one party serving as a general partner and at least one party serving as a limited partner. Just like in a general partnership, the general partners in a limited partnership are jointly and severally liable for the partnership's debts and obligations. The limited partners, on the other hand, are not personally liable. Limited partners are liable for the amount of capital that they contributed to partnership, but nothing more. This makes sense because a limited partner's capital contributions become the assets of the partnership, and are no longer solely the personal assets of the limited partner.

Much like shareholders in corporations, the law gives limited partners limited liability because limited partners do not have any management responsibilities. The separation of ownership and management is a mechanism through which the law limits personal liability. Limited partnerships can be very attractive for passive investors who do not want any management responsibility. For more active investors, like venture capital firms, a limited partnership interest would probably not be ideal.

There are two other important considerations that come along with the split between management and ownership. First, if a limited partner starts managing the partnership and behaving more like a general partner, the limited partner risks losing limited liability protection. Courts will hold a limited partner personally liable if the limited partner acts like a general partner, regardless of what the partnership agreement says. Second, a limited partnership interest is a security because it is an ownership interest in a venture over which the limited partner has no management authority. Much like shares of stock, you must ensure that the offer and ownership of a limited partnership interest complies with all relevant securities regulations. Please consult a business law attorney on these issues.

Like general partnerships, the law that regulates limited partnerships varies from state to state. Many states, however, have codified the Uniform Limited Partnership Act of 2001, which governs the organization and operation of limited partnerships. See <http://www.law.upenn.edu/bll/archives/ulc/ulpa/final2001.pdf> (PDF copy of the Act).

General partners almost always owe fiduciary duties of care, loyalty, and good faith and fair dealing to all other partners and to the partnership itself. Although laws differ, limited partners generally owe no fiduciary duties.

Taxation

Limited partnerships are treated like a general partnership for tax purposes. Please see the tax discussion under "General Partnerships" for more information.

Some states, like California, require limited partnerships to pay an annual franchise tax.

Formation

The formation of a limited partnership usually entails two steps: 1) entering into a limited partnership agreement; and 2) filing the necessary certifications with your Secretary of State. The limited partnership agreement will be very similar to a general partnership agreement. The key difference is that a limited partnership agreement will lay out the differences between a general partnership interest and a limited partnership interest, as well as identify who owns what kind of interest.

For more information on forming a limited partnership, visit your Secretary of State's website and contact a business law attorney.

Summary

Limited partnerships offer an entrepreneur the opportunity to seek capital and investment from outside sources, but still retain the ultimate control over the management and operation of the business. A general partner must be careful, however, to determine how and under what circumstances a limited partner can bind the partnership to a debt or obligation. This is because all partnership obligations will become the general partners' personal obligations.

Limited Liability Partnerships

Organization and Structure

A limited liability partnership ("LLP") is a general partnership where the partners are severally, but not jointly, liable. In other words, partners in an LLP are personally liable for the debts and obligations that each partner personally guarantees, but are not personally liable for the debts and obligations of the other partners or of the partnership as a whole. General partners owe the same fiduciary duties as general partners in a limited partnership.

LLP's are not a common business entity for a number of entrepreneurs as LLP's are typically reserved to certain professions, namely those of attorneys, accountants, and architects. In fact, some states, like California, limit LLP's to just legal, accountancy, and architectural firms. Because this business entity is traditionally restricted to these professions, this guide will not treat LLP's in depth. For further information on this business entity, please contact a business law attorney.

Taxation

For income tax purposes, LLP's are treated like general partnerships.

Formation

An LLP ordinarily begins as a regular general partnership. After formation, the partners will then elect to register as an LLP with the Secretary of State. As part of such registration, the partners will have to amend the partnership agreement to reflect the LLP status and obligations.

Summary

An LLP, if available to an entrepreneur, offers the benefits of a general partnership without the significant drawback of each partner being jointly and severally liable for the partnership's debts and obligation. The major restriction to forming an LLP is that this entity is often reserved to certain industries.

Limited Liability Limited Partnerships

Organization and Structure

A limited liability limited partnership ("LLLP") is a limited partnership where the general partners are severally, but not jointly, personally liable. In other words, an LLLP is to a limited partnership what an LLP is to a general partnership. A limited partner in an LLLP is liable for the amount of capital contributed to the business, just like in a limited partnership. A general partner in an LLLP is liable for those debts and obligations that he or she personally guarantees, but is not liable for the debts and obligations of the other partners or the LLLP as a whole.

Whereas LLP's have been in use in the United States for some time, LLLP's are a relatively recent phenomena to our country. As such, the law on LLLP's is burgeoning and inchoate. Only a handful of states even allow LLLP's, some of which include Arkansas, Colorado, Delaware, Florida, Hawaii, Georgia, Maryland, Nevada, Texas, and Kentucky.

As with limited partnerships, the limited partnership interests in LLLP's are securities.

For more information on LLLP's, please consult a business law attorney and/or search your Secretary of State's website. See, e.g., <http://www.sos.state.nv.us/business/forms/lllp.asp> (Nevada Secretary of State's website regarding LLLP's).

Taxation

The states which allow LLLP's treat them like general partnerships for income tax purposes.

Formation

LLLP's are formed one of two ways, depending on state law. One method is analogous to LLP's: the partners enter into a limited partnership agreement, and then later make an LLLP

election, register with the Secretary of State, and amend the limited partnership agreement to reflect the entity change. The other method is to simply make the LLLP election at the time of filing the certificate for a limited partnership.

Summary

An LLLP offers an entrepreneur the benefits of a limited partnership without the significant drawback of the general partners being jointly and severally liable for the partnership's debts and obligation. The major drawback to an LLLP is that this entity is available only in a few states. Additionally, the laws regarding this entity are not as well-developed because it is such a new entity.

Limited Liability Companies

Organization and Structure

A limited liability company ("LLC") is commonly described as a mix or hybrid between a corporation and a general partnership. An LLC is similar to a corporation in that it has limited liability for *all* of its "members," unlike a limited partnership where only the limited partners enjoy limited liability protection.

An LLC is similar to a general partnership in that an LLC is a flow-through entity for income tax purposes. To be more precise, an LLC has the option of being taxed as either a C corporation (double taxation) or a general partnership (flow-through), but, in reality, LLC members almost always elect flow-through entity status.

The owners of an LLC are all referred to as "members," although there can be different kinds of membership interests with varying rights and levels of responsibilities. For instance, some members can be "manager members" with full management responsibility for the company. On the other hand, other members can have what is referred to as a "passive member interest" or "economic interest" in the company. Such members have no management responsibility, but still contributed capital at the time of formation and share in the company's profits and losses.

LLC's are relatively new and add a twist to our traditional understanding of limited liability business entities. This is because the law has allows for limited liability in other business entities only when ownership and management are separated. In an LLC, however, the members that manage the company enjoy the same limited liability as passive members. Please be aware that, like with corporate law, courts will pierce the limited liability veil of LLC's if the members breach fiduciary duties (often by making "improper distributions" to themselves) or if a member personally guarantees an obligation. Please consult a business law attorney in order to learn more about these issues.

In terms of securities regulations, LLC's can be the tricky. Unlike shares of stock or limited partnership interests, which are clearly defined as securities, LLC membership interests are defined as securities on a case-by-case basis. This is because it is not always obvious whether an LLC member has management responsibilities. Again, the general rule of thumb is that if you have an economic interest in an enterprise over which you have no management authority, then your interest qualifies as a security. Please consult a business law attorney experienced in this area of law to sort through these issues with you.

Like other business entities, the law that controls LLC's varies from state to state. Many states, however, have codified the Revised Uniform Limited Liability Company Act of 2006, which governs the organization and operation of LLC's. See http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_final.htm (PDF copy of the Act).

Taxation

As discussed above, LLC's can elect to be taxed as either a C corporation or as a general partnership. To add a wrinkle, a single member LLC with no employees can elect a disregarded entity status similar to that of a sole proprietorship. To add another wrinkle, if a husband and wife in a "community property state" (like California) are the only members of an LLC, then they can elect disregarded entity status because their marital union can constitute a single membership interest.

Also as discussed above, LLC's are often compared to S corporations because both have limited liability for all owners and both are flow-through entities for income tax purposes. For a discussion of the differences between an LLC and an S corporation, please refer to tax subsection of the "General Partnership" section above.

Some states, like California, require LLC's to pay an annual franchise tax.

Formation

Forming an LLC is essentially a two-step process: 1) the potential members must file the Articles of Organization with their Secretary of State; and 2) the potential members must enter into an "operating agreement." Under most states' laws, both steps must be completed before an LLC is brought into existence. At the time the potential members enter into the operating agreement, they will also fund the LLC with capital contributions and receive membership interests in return.

The Articles of Organization are relatively easy to complete and file as they are usually just a fill-in-the-blank form available on the Secretary of State's website. See, e.g., <http://www.sos.ca.gov/business/llc/forms/llc-1.pdf> (LLC form on California's Secretary of State's website). The Articles usually include the following provisions: 1) the name of the LLC; 2) statement of the LLC's purpose; 3) the full name and address of initial agent for service of process; and 4) how and by whom the LLC will be managed.

After the Secretary of State approves and certifies the Articles, the potential members will then enter into an operating agreement and contribute capital to the business. Although such agreements can vary widely, some common sections include the following: 1) the amount of and by whom capital contributions will be made; 2) the identities of the members and the nature and percentage of their interests; 3) how the LLC will be managed; 4) how the profits and losses will be allocated (remember this is a key difference between an LLC and an S corporation); and 5) how and under what circumstances the LLC will dissolve.

For further guidance on forming an LLC, please review your Secretary of State's website and consult a business law attorney.

Summary

The LLC offers an entrepreneur the benefits of limited liability coupled with favorable tax treatment. Unlike LLLP's, the LLC entity is far more ubiquitous and has more developed law. Additionally, an LLC can be easier and cheaper to organize than a corporation. Be careful when forming an LLC, however, as doing so can trigger complicated securities issues.

Joint Ventures or Strategic Alliances

Joint ventures or strategic alliances are essentially relationships between individuals or entities that 1) are formed by contract, 2) exist for a limited period of time or until a particular goal or milestone is achieved. They are essentially arrangements between businesses to accomplish a specific purpose. They do not form a new business entity, although most states' laws will apply general partnership law to them.

Please consult a business law attorney for further research in how to form and operate a joint venture or strategic alliance.

Conclusion

There are some important issues in forming a business entity that apply regardless of the form of entity you choose. Some of these issues include: 1) ensuring that the name of your business is "available" with the Secretary of State; 2) ensuring that the name of your business does not infringe another's trademark; 3) notifying national, state, and local tax authorities of your business's existence; 4) obtaining all necessary permits, licenses, and exemption to operate your business; 5) ensuring that you have robust intellectual property protection; 6) ensuring that your business is properly insured; and 6) ensuring that if you hire employees, you comply with all relevant employment regulations, have the necessary insurance coverage (for worker's compensation and the like), and have a well-drafted employee policy.

The foregoing hopefully provided you with a general, yet substantive, overview of the most commonly used business entities. The information in this chapter should not substitute for your own thorough research and the advice of an attorney who specializes in business law.

	Taxation	Ownership and Management	Liability	Formation	Benefits	Drawbacks
Sole Proprietorship	“Disregarded Entity” for income tax purposes; must pay self employment tax.	Sole proprietor is the only owner and manager.	Unlimited personal liability for the owner of the business	Simply start operating the business; file all necessary permits and licenses.	Complete management autonomy; easy, fast, and cheap to form.	Unlimited personal liability; limited options for business financing.
C Corporation	“Double taxation” at 1) corporate and 2) shareholder level.	Shareholders are owners; officers manage day to day operations; directors manage overall policy and direction.	Limited liability for shareholders, subject to piercing the corporate veil.	Essentially: 1) Articles of Incorporation; 2) Bylaws; 3) appoint directors; 4) issue stock and appoint officers	Malleable entity; developed law; limited liability; attractive to investors; many financing options.	Relatively more costly and time consuming to form and operate; double taxation.
S Corporation	“Flow through” taxation: only taxed at the shareholder level.	Same as above.	Same as above.	Same, but also must make S Corporation election with IRS form 2553.	Same, plus no double taxation.	Same, except no double taxation.
General Partnership	“Flow through” taxation: entity itself pays no taxes.	All partners own and manage the business.	Each partner is “jointly and severally” liable.	Enter into partnership agreement.	Shared management and financing responsibility.	Personally liable for all debts/obligations of partnership.
Limited Partnership	Same as above.	All partners own; only general partners manage.	General partners same as above; limited partners have limited liability.	1) Enter into partnership agreement; 2) file necessary certificates with SOS.	Limited liability for some partners; beneficial entity for many investors.	General partners are still personally liable.
Limited Liability Partnership	Same as above.	All partners own and manage the business.	“Several liability” for each partner: only liable for own obligations, not other partners’.	1) Enter into partnership agreement; 2) file necessary registration with SOS.	Liability for all partners limited only to that partner’s obligations.	This entity is usually limited to lawyers, accountants, and architects, only.
Limited Liability Limited Partnership	Same as above.	All partners own; only general partners manage.	Limited liability for limited partners; several liability for general partners.	1) Enter into partnership agreement; 2) file necessary registration with SOS.	Limited liability for some partners and only several liability for other partners.	This entity is only available in a handful of states and is very new.
Limited Liability Company	Same as above.	All members own; only one to all members can manage	Limited liability for all members, even for managing members.	1) File Articles of Organization with SOS; 2) enter into an operating agreement.	Limited liability for all members; no double taxation (often compared with an S Corporation)	Securities issues can be difficult; not as many financing options as with a corporation.

Section 2: Intellectual Property Law

Introduction

This section of the legal guide is intended to provide you with a basic overview of the four common types of intellectual property protection: 1) trademarks; 2) copyrights; 3) patents; and 4) trade secrets. For each, this guide will discuss the kinds of intellectual property these areas of law protect, the rights and responsibilities they confer, their benefits and disadvantages, and the general procedures for acquiring, maintaining, and enforcing your rights. Where applicable, this guide will also touch upon how these areas of law intersect with the Internet.

The information in this section is meant as a starting point for your continued research. The goal is to provide you with a general understanding of what kinds of intellectual property protection are available. Hopefully you will be able to use this information as you begin to review your and your business's intellectual property inventory. As always, you should consult with an intellectual property attorney before undertaking any actions or making any decisions that could affect your rights.

Trademarks

Definition and Background

Trademark law is designed to protect anything that helps to identify and distinguish your goods or services from anyone else's goods or services. Although trademark law encompasses "trademarks," "servicemarks," and "trade dress," this guide will use the term "mark" to refer to all three for the sake of brevity.

To be clear, a "trademark" is "any word, name, device, or symbol or any combination thereof . . . [used] to identify and distinguish [your] goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown." 15 USC § 1127. Whereas, a "servicemark" has the same basic definition, but is used to identify and distinguish the source of the services rendered. *Id.* And, "trade dress" is the same thing as a trademark or servicemark, but is colloquially defined as the "look and feel" aspect of a trademark. For instance, the distinctive red and white markings on a Marlborough cigarette pack constitute protectable trade dress, completely separate from any words, names, or symbols on the pack.

Trademark protection can also extend to sounds, color schemes, and domain names. For instance, the "potato potato" sound made by a Harley Davidson motorcycle has been trademarked. The key inquiry is always whether the name, sound, or color/dress scheme identifies the source of the goods or services. If it accomplishes this goal, then trademark protection is possible.

Ordinarily, trademark protection does not extend to a “trade name.” A trade name is simply the name used to identify the business or vocation. 15 USC § 1127. In other words, it is the name of your business. The protection normally extended to trade names is the “doing business as” you would file with your county. A trade name does merit trademark protection, however, if it acquires “secondary meaning” or “acquired distinctiveness,” which means that the trade name has come to identify the source of the goods or services. 15 USC § 1052(f). All things being equal, any name or symbol acquires trademark rights once consumers begin to use that name or symbol as an identifier of the source of the goods or services.

As an entrepreneur who is looking to use a mark to market your products or services, the most important initial step is to perform a thorough trademark search. This is a crucial, and relatively easy, step that is frequently overlooked. You will save considerable money in the long-run by ensuring at the outset that your mark will not infringe or dilute another’s trademark. There are services and websites devoted to searching preexisting trademarks. You can start an informal search yourself by using a search engine or searching the United States Patent and Trademark Office’s (“USPTO”) website at www.uspto.gov. For a legal opinion regarding the strength of your proposed mark, please consult an intellectual property attorney.

Spectrum of Distinctiveness

A mark’s strength—i.e. its ability to attain trademark protection—depends on the nature and content of the mark, and the relationship between the mark and the goods or services it markets.

In trademark law, marks fall somewhere along a “spectrum of distinctiveness.” The general rule of thumb is that the more distinctive a mark, the more likely it will merit trademark protection. This is because the more distinctive a mark, the more likely it will identify the source of goods or services. Going from generic to more distinctive, marks are categorized along the spectrum of distinctiveness as follows:

1) Generic Marks:

A generic mark is one that is synonymous with what the product is. A mark that is generic cannot be trademarked. For instance, you cannot trademark “Desk” to sell desks. This is because generic terms identify the product itself, and not the source of the product.

Interestingly, a previously valid trademark can become generic, and thereby lose trademark protection. Businesses must be vigilant to protect their trademarks against “genericide.” The best way to protect your trademark is to always use it as an adjective, and not as a noun. For instance, “Thermos” lost trademark protection because it became the generic name, or noun, for a thermos. It could have been protected if the company had marketed its product as “Thermos” (adjective) brand “hot liquid container” (noun).

2) Descriptive Marks:

A descriptive mark is one that describes an attribute of the product or services. A descriptive mark can be trademarked only if it has gained secondary meaning. 15 USC § 1052(e). The reason for this rule is that competitors are allowed to market similar products using similar terms because those terms describe what the product is.

If a descriptive mark comes to identify the source of the goods in the mind of consumers, and is no longer merely an attribute of the goods, then the mark is trademarkable. For example, “Wooden” brand desks would be descriptive because it describes the physical attribute of the desks. Unless this gained secondary meaning, it could not be trademarked. To take a real life example, “Frosted Mini Wheats” is descriptive because it describes attributes of the cereal product, but it has been trademarked because consumers now identify this descriptive mark with the source of the goods.

3) Suggestive Marks:

Suggestive marks are those marks that exist somewhere between descriptive marks and arbitrary and fanciful marks (described below). A suggestive mark alludes to some characteristic of the product or service, but does not specifically describe that characteristic. The contours of this category are usually somewhat hazy.

Suggestive marks can usually be trademarked without secondary meaning because they already identify the source of the goods or services. To continue with our desk examples above, a suggestive mark for desks might be the “Hardwork” brand desk. A real life example would be “Microsoft” because it alludes to the products as being software for computers.

4) Arbitrary and Fanciful Marks:

Arbitrary and Fanciful marks are the strongest marks, and generally merit trademark protection. A mark is arbitrary and fanciful if it neither describes nor suggests anything about the product or service. Often times these are called “coined” marks because they are made only in reference to the source of the goods or services identified, and have no other meaning. “Kodak” is a classic example.

As with all of these marks, the relationship between the mark and the product or service helps determine what category the mark falls into. For instance, “Apple” brand apples would be generic, and would not merit trademark protection. But, “Apple” brand computers is arbitrary and fanciful, and currently enjoys trademark protection.

Marks that Cannot be Trademarked

Independent of where a mark falls on the spectrum of distinctiveness, there might be other reasons why a mark cannot be trademarked. The Lanham Act—the federal statutory

scheme dealing with trademarks—provides a list of marks that cannot be trademarked. *See* 15 USC § 1052. Some of the kinds of marks that cannot be trademarked include:

1) Marks that are “immoral” or “scandalous.” 15 USC § 1052(a).

It is usually quite easy to identify marks that fit into this category. For instance, marks that contain pornographic words or images commonly are disallowed trademark protection on immoral and scandalous grounds. These kinds of marks cannot be trademarked even if they acquire secondary meaning.

2) Marks that disparage people, groups, institutions, beliefs, or national symbols. 15 USC § 1052(a).

Like immoral or scandalous marks, marks that are disparaging are usually quite easy to identify. For example, a trademark that featured a large “X” superimposed over a hammer and sickle was held to disparage the national symbol of the Soviet Union. These kinds of marks cannot be trademarked even if they acquire secondary meaning.

3) Marks that are “deceptive.” 15 USC § 1052(a).

A mark is deceptive if it 1) misdescribes the product or service, 2) consumers would tend to believe the misdescription, and 3) the misdescription would impact the consumers’ buying decision. For instance, “Healthy” brand cigarettes would be deceptive. These kinds of marks cannot be trademarked even if they acquire secondary meaning.

Please note that a mark can misdescribe a product without being deceptive. This happens where the misdescription is not something a consumer would believe. These are simply “misdescriptive” marks, and can merit trademark protection. For instance, “Ivory” soap misdescribes the soap as having something to do with elephant tusks, but (hopefully) no consumer would believe that this brand of soap is made from actual ivory.

4) A mark that is geographically deceptively misdescriptive. 15 USC § 1052(e)(3).

A mark is geographically deceptively misdescriptive if 1) the mark describes a geographic place, 2) the goods do not come from that place, and 3) consumers would believe that the goods came from this place. For instance, “Bahia” brand cigars were geographically deceptively misdescriptive as they did not come from the Bahia province of Cuba. These kinds of marks cannot be trademarked even if they acquire secondary meaning.

5) Marks, dress, or matter that is “functional.” 15 USC § 1052(e)(5).

The idea behind disallowing trademark protection to “functional” aspects of a mark is fairness to competitors. If there is an aspect to a product that is necessary to make the product what it is, one company cannot prevent others from using that necessary aspect by claiming

trademark rights over it. *See, e.g., Brunswick Corp. v. British Seagull Ltd.*, 35 F.3d 1527 (Fed. Cir. 1994)(no trademark protection for black outboard motors because the color black had identifiable competitive advantages with regard to parts coordination and engine size). These kinds of marks cannot be trademarked even if they acquire secondary meaning.

This restriction is particularly problematic in attaining trademark rights in a product's trade dress. This is because the trade dress, or "look and feel," of a product is sometimes arguably essential to what the product is. For instance, whether a website's look and feel is protectable trade dress or merely functional is currently a live issue.

6) Marks that are "deceptively misdescriptive" (unless they acquire secondary meaning). 15 USC § 1052(e)(1).

A mark is deceptively misdescriptive if it 1) misdescribes the product or service and 2) consumers would tend to believe the misdescription. Unlike a deceptive mark, a deceptively misdescriptive mark does not impact consumers' buying decisions. For instance, "Woolrich" is deceptively misdescriptive of clothing that is not actually made out of wool. These marks can merit trademark protection if they gain secondary meaning. 15 USC § 1052(f).

The difference between a deceptive mark and a deceptively misdescriptive mark is often found only through vigorous litigation. Unless you are wedded to a misdescriptive mark, consider avoiding anything misdescriptive just to be on the safe side.

7) Marks that are "geographically descriptive" (unless they acquire secondary meaning). 15 USC § 1052(e)(2).

A mark is geographically descriptive if 1) the mark describes a geographic place, 2) the goods do come from that place, and 3) consumers would believe that the goods came from this place. Trademark protection is ordinarily not allowed for such marks because these marks identify the *geographic* source of the goods, and not the *business* that is the source of the goods. These marks can, however, merit trademark protection if they gain secondary meaning. 15 USC § 1052(f). For instance, "Nantucket Nectars" is geographically descriptive because much of business operations were located in and distributions come from Nantucket, but it is trademarked because it acquired secondary meaning.

8) Marks that are merely a surname (unless they acquire secondary meaning). 15 USC § 1052(e)(4).

If a mark is simply your last name, it ordinarily cannot be trademarked because it does not identify the source of goods or services. These marks can, however, merit trademark protection if they gain secondary meaning. 15 USC § 1052(f). The classic example is "McDonald's," which is a surname, but has assuredly gained trademark protection.

This and the previous section are intended as a basic categorization of the most common kinds of marks. For continued research, you can review the Lanham Act at 15 USC §§ 1051–1128. As always, you should consult with an intellectual property attorney in order to determine the strength of your mark.

Rights in Marks

The basic legal right you have in your trademark is to prevent others from using the same or a confusingly similar mark to identify the source of their goods or services where this would cause confusion in the mind of consumers. Acquiring trademark rights is relatively simple: all you must do is begin using your mark in commerce. This makes sense because trademark law protects those marks that identify the source of the goods or services in the mind of consumers. The mark must be used in commerce in order for consumers to be aware of it and to make the connection between the mark and your goods or services.

The first user of a mark is usually given priority of rights. For instance, if you federally register your mark and your competitor did not, your competitor might still be able to sue you for trademark infringement if your competitor began using the mark first. If, however, a foreign company is the first to use a mark exclusively outside the U.S., our trademark law will generally not give that company trademark rights over a later user of a similar mark in the U.S.

A) State Law

Trademark law consists of both state law (often comprised of “common law”) and federal law. Under state law, use of a mark confers trademark rights. These rights extend to the geographic area where the mark is used and where the reputation of the mark extends. Some states extend the geographic reach of trademark protection under the “Zone of Expansion” doctrine, which recognizes that a business will likely enter into broader geographic areas in the future, and thereby presently extends trademark protection to such areas.

You can enforce your trademark rights using your state’s unfair competition laws. These laws give you the right to sue for infringement (or “passing off”) or dilution. Infringement occurs when a competitor uses a mark that will likely cause confusion in the mind of the consumers as to the source of the goods or services. For example, if you began selling “Crestor” brand toothpaste, this would infringe on the trademark for “Crest” brand toothpaste because such a similar name would cause confusion in the minds of the consumers.

Dilution, on the other hand, takes on two forms: blurring and tarnishment. For either form, a dilution action is only available for those marks that have become sufficiently “famous.”

Blurring occurs when a competitor’s mark weakens the association in the mind of the consumers between your mark and the source of your goods or services. For example, if someone began selling “Viagra” brand tennis rackets, the association between “Viagra” and the little, blue pill would become weakened in the minds of the consumers.

Tarnishment occurs when a competitor's mark creates a negative association in the minds of the consumers between your mark and the source of your goods or services. For example, if someone began selling "Sony" brand personal enemas, a negative association would form in the minds of consumers regarding the mark "Sony."

Based on the examples above, you can see that dilution usually occurs when the two products in question are very different. The crucial thing to remember is that with dilution, consumers are not confused about the source of the goods or services, like with infringement. For instance, consumers would not be confused into thinking that Pfizer started making "Viagra" brand tennis shoes. Instead, the quick association of a famous mark with its product is attenuated. Another difference between dilution and infringement is that a dilution claim usually requires proof of the *actual* impact on the mind of consumers; whereas, an infringement claim usually requires proof of mere *likelihood* of confusion.

B) Federal Law

Federal trademark law is codified in the Lanham Act at 15 USC §§ 1051–1128. Much like state law, federal law gives you the right to prevent competitors from using your mark or a similar mark, so long as you can prove that their mark is likely to cause confusion in the mind of the consumers. Because these cases turn on "likelihood of confusion," federal case law has established several areas of inquiry that will aid a court's analysis of this issue:

- 1) The similarity of marks;
- 2) The respective "channels of trade" of the parties;
- 3) The similarity of the goods or services;
- 4) The sophistication of the relevant consumers;
- 5) Evidence of actual confusion;
- 6) The alleged infringer's intent; and
- 7) The strength of the plaintiff's mark.

See AMF, Inc. v. Sleekcraft Boats, 599 F.2d 341 (9th Cir. 1979).

Like state law, federal law also gives trademark holders the right to pursue a dilution action. *See* the Federal Trademark Dilution Revision Act at 15 USC § 1125(c). A plaintiff in a federal dilution action must prove that 1) the plaintiff's mark is "famous," 2) the defendant used its mark in commerce after the plaintiff's mark became famous, and 3) the defendant's use of its mark has caused dilution by blurring or tarnishment. Federal dilution protection extends only to

“famous” marks, which makes sense because only well-known marks have the potential to be diluted in the mind of the consumers. Federal law also provides an injunction remedy.

For more information on your state and federal trademark rights, please review the legal authorities cited herein and consult with an intellectual property attorney.

Registration

A) State

As discussed above, local trademark rights are triggered once you use the mark in commerce. State registration, however, provides state-wide “constructive notice” of your ownership of your mark. This means that, within your state, any later user of your mark or a confusingly similar mark is presumed to have known about your mark and its protected status. In order to determine how to register your mark at the state level, please consult your state’s Secretary of State’s website and talk with an intellectual property attorney. *See, e.g.*, <http://www.sos.ca.gov/business/ts/> (California Secretary of State’s trademark website).

Please note that some states allow you to file an “intent to use” application to reserve your trademark prior to using it in commerce. In those states that allow such registration, you must use the trademark in commerce within a specific number of months after the application has been filed. For California entrepreneurs, that state does not allow an intent to use application.

B) Federal

Registering your mark with the USPTO is not necessary to acquire local trademark rights, but is highly advisable as federal registration confers significant benefits. Those benefits include the following:

- 1) A federal registrant will always have federal “subject matter jurisdiction,” meaning you can always bring your infringement or dilution claim in federal court (15 USC § 1121);
- 2) Certain damages are available to federal registrants only (15 USC § 1117);
- 3) Federal registration is “prima facie” evidence (meaning a court will accept it as true unless the defendant proves otherwise) of the validity of the registration, the trademark itself, your ownership of the trademark, and your exclusive right to use the trademark (15 USC § 1057(b)); and
- 4) Federal registration is constructive notice across the whole United States of your ownership of your trademark (15 USC § 1072).

The process of federally registering your trademark involves filing the relevant application with the USPTO. The necessary application and the required contents of that application will depend on the characteristics of your mark. For instance, the application process for a mark that is a sound or color scheme will be different than the registration process for a mark that is a word or symbol. For your continued research into the application process and requirements, you can review 15 USC § 1051 and consult the online registration site at www.uspto.gov/teas and the “forms” site at <http://www.uspto.gov/teas/e-TEAS/index.html>. Before you undertake the process of federally registering your mark, please consult an intellectual property attorney.

Unlike some state laws, federal law allows you to file an intent to use application with the USPTO. After filing this application, however, you must use your mark in commerce within six (6) months. If you do so, the “first use” date of your mark will be considered the date of filing of the intent to use application. See <http://www.uspto.gov/teas/eTEASpageB2.htm> (federal intent to use application).

C) International

In order to gain international trademark protection, you ordinarily have to have already federally registered your trademark in the United States. You must also have a product or service that will be marketed in the relevant foreign countries in which you are seeking trademark protection.

Although each country’s trademark laws are different, certain countries have agreed to allow a single application for all of the member countries. This agreement is the Protocol Relating to the Madrid Agreement Concerning International Registration of Marks, colloquially referred to as the “Madrid Protocol.” See 15 USC § 1141; www.wipo.int/madrid/en (website regarding international registration). This application is submitted to the World Intellectual Property Organization (WIPO) for review. Please consult an intellectual property attorney regarding the procedures for acquiring international trademark protection.

Marks and the Internet

Domain names, like trade names, do not merit trademark protection unless they have acquired secondary meaning. This is just a straight-forward application of the general trademark law we have seen above. Domain names, however, do have several intellectual property laws that apply just to them.

The federal Anticybersquatting Consumer Protection Act (“ACPA”) at 15 USC § 1125(d) is designed to protect businesses from “cybersquatters” who have a bad faith intent to profit. A cybersquatter is someone who purchases the domain name of a famous mark with a bad faith intent to profit by reselling the domain name to the company who owns that mark. For instance, if someone had purchased www.cocacola.com before Coca-Cola did, and then attempted to sell or license that domain name to the company for an exorbitant fee, this would be cybersquatting.

This Act allows for “in rem” actions against the domain name itself. This means the plaintiff need not determine who the cybersquatter is in order to bring a lawsuit; a plaintiff may maintain an action against the domain name itself, and still obtain adequate relief.

If you have a potential dispute involving a domain name, you can litigate the matter in court, but this option is often costly and lengthy, as is often the case with litigation. As an alternative, the Internet Corporation for Assigned Names and Numbers (ICANN) has implemented the Uniform Domain Name Dispute Resolution Policy (UDRP) as a dispute resolution mechanism regarding domain names. The UDRP proceedings are all conducted via email and resolved by an arbitration panel in a summary manner. The benefit of UDRP is that it is fast and inexpensive, but the only remedies available are to change, cancel, or transfer the infringing domain name. If you desire monetary or injunctive relief, you must pursue your case in court. For more information on UDRP, please visit www.icann.org/udrp. When deciding which avenue to pursue, consult an intellectual property attorney.

Please note that there are new, live issues regarding the use of another’s trademark as a metatag in online advertisements. This is an important issue with regard to search engine optimization (“SEO”), search engine marketing (“SEM”), and other online media marketing. Consult an intellectual property or Internet law attorney to learn the latest.

Summary

When deciding on a trademark, the most important initial step is to conduct a trademark search to ensure that your desired mark would not infringe or dilute another’s mark. You can begin the process yourself using a search engine or by visiting www.uspto.gov. There are businesses that can conduct a search for you, as well. As always, you should protect yourself by attaining a legal opinion regarding the strength of your mark. The important question to always ask yourself is what would be the impact of your mark in the minds of the consumers.

Copyrights

Definition and Background

Copyright law is designed to protect your “original works of authorship fixed in a tangible medium of expression.” See 17 USC § 102. Copyright protection begins the moment that any such original work becomes fixed in such a medium. This makes copyright law similar to trademark law in that there is no affirmative act of registration or any application process that is required to gain intellectual property protection. Breaking the definition of a copyright apart, this subsection will address 1) what is an original work, 2) who is the author, and 3) what does it mean to be fixed in a tangible medium of expression.

First, a work is original if it required some minimal degree of creativity to create and is not substantially similar to another author’s copyrighted work. The originality requirement reflects a very important concept in copyright law: the “idea/expression dichotomy.” Copyright

law protects the expression of an idea, but not the idea itself (compare this to the later discussion of patents, which do protect an idea). For instance, if William Shakespeare were to have written *Romeo and Juliet* today, he would have copyright protection over the expressive content of the work, but not over the idea of two lovers whose families are rivals. If another author created a wholly original work based on the same premise, Bill would not win an infringement lawsuit.

Second, the author of the work is the copyright holder. Surprisingly, this can be a complicated issue. In the case of multiple authors, each author will have copyright protection over the entire work only if there was unanimous, mutual intent to that effect. If there was no mutual intent, then each author has copyright protection over only that portion of the work that the given author created.

Authorship is of particular importance to businesses that have employees or independent contractors who are creating copyrightable intellectual property, such as software. Applying the general rule above, the holder of the copyright would be the employee or independent contractor, and not the company. Federal law, however, has a “work made for hire” doctrine that gives copyright protection to the employer company if an employee creates a copyrightable work within the scope of his or her employment. *See* 17 USC § 101. Please be aware, however, that this rule does not extend to independent contractors. If you want copyright protection over your independent contractor’s work product, you must negotiate for an assignment of intellectual property rights. *See* 17 USC § 204. Please be advised that website developers are usually independent contractors; therefore, absent an assignment of rights, you might not be the copyright holder of your website.

Third, the “fixation” requirement is usually not difficult to achieve. Courts tend to construe liberally what is a tangible medium of expression. The fixation requirement can become tricky with regard to computer code, which is copyrightable intellectual property. For instance, there is currently a live issue as to whether copies of computer code in random-access memory (“RAM”) are fixed in a tangible medium of expression under the federal Digital Millennium Copyright Act (“DMCA”). *See* 17 USC §§ 512, 1201–05, 1301–32; *see generally* <http://www.copyright.gov/legislation/dmca.pdf>. Please consult an intellectual property attorney for further instruction on the issues discussed in this subsection.

Rights in Copyright

Depending on the nature of the work, copyright protection confers several exclusive rights on the copyright holder pursuant to 17 USC § 106. These rights include:

- 1) The right to reproduce copies of the work;
- 2) The right to create derivative works;
- 3) The right to publically distribute copies of the work; and

4) The right to display and/or perform the work.

Having these exclusive rights means that the copyright holder can prevent others from engaging in these activities. More importantly, however, the copyright holder can license each of these rights independently from the other rights. See 17 USC § 201(d); www.copyright.gov/circs/circ12.pdf. In other words, you can give a vendor a license to create and distribute copies of your work without also giving that vendor a license to create derivative works.

Please be aware that Internet advertising and “linking” can sometimes infringe on another copyright holder’s right to make derivative works. You should consult an intellectual property law or Internet law attorney for more information.

The duration of copyright protection under federal law depends on who the author is. If the author is an individual or individuals, then the copyright lasts for the life of the author plus seventy (70) years. 17 USC § 302(a). If the work is a work made for hire, then the copyright lasts ninety five (95) years from date of first publication, or one hundred twenty (120) years from the creation of work, whichever is shorter. 17 USC § 302(c).

For the proper contents of a copyright notice (i.e. the © symbol), please also review 17 USC § 401.

The basic copyright legal remedy is to sue for infringement. Although copyright infringement is typically a federal cause of action, you may sue for infringement or “misappropriation” under your state’s unfair competition laws. Regardless of the jurisdiction, to win an infringement action, you generally have to prove 1) that you own the copyrighted work in question, 2) the defendant had access to the copyrighted work, and 3) there is probative or substantial similarity between the copyrighted work and the allegedly infringing work.

The defendant in an infringement suit need not be the actual infringer. It is possible to bring an infringement suit against a third party via either “vicarious” or “contributory” liability. See generally *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005)(vicarious liability); *Sony Corp. v. Universal City Studios, Inc.*, 464 U.S. 417 (1984)(contributory liability). For vicarious liability to attach, you normally have to prove that the third party 1) had control and knowledge of the primary defendant’s infringing activities, and 2) that the third party derived a financial benefit from said infringement. See *Grokster*. For contributory liability to attach, you normally have to prove that the third party 1) had knowledge of the primary defendant’s infringing activities, 2) “induced” the primary defendant to infringe your copyright, and 3) that the third party defendant and the primary defendant had a continuing relationship. See *Sony*. Please note that the contours of “third party liability” for copyright infringement are always in flux as this is an area of law that continues to evolve. Please consult an attorney for further instruction on these issues.

Limitations on Rights

This guide will briefly touch on three potential limitations on your copyright rights: 1) the “fair use doctrine;” 2) the “first sale doctrine;” and 3) certain safe harbors for copying computer programs.

The fair use doctrine essentially states that a copyright holder cannot prevent another from using the holder’s copyrighted material for certain purposes: “criticism, comment, news reporting, teaching, scholarship, or research.” *See* 17 USC § 107. When analyzing whether the fair use doctrine applies as a defense to infringement, courts will look at four factors:

- 1) The nature of the use (if the use is not for profit, then it is more likely to be a fair use than if it is for commercial purposes);
- 2) The nature of the copyrighted work (if the copyrighted work is factual or nonfiction, then the use is more likely to be a fair use than if the copyrighted work is fictional);
- 3) The amount and substantiality of the portions taken from the copyrighted work as whole (the more that is taken from the copyrighted work, the less likely the use is a fair use); and
- 4) The effect on the potential market for the copyrighted work (if the allegedly infringing work hurts sales of the copyrighted work, then the less likely the use is a fair use).

See 17 USC § 107.

Please consult an intellectual property attorney to determine whether another’s use of your copyrighted material or your use of another’s copyright material is a fair use. Please also note that the fair use doctrine has interesting applications with regard to “reverse engineering” copyrighted software.

The first sale doctrine essentially states that once a copy of a copyrighted work is sold by copyright holder, the buyer may retransfer that copy without the consent of the copyright holder so long as the buyer has not made any changes to the copyrighted work. For instance, if you buy the latest John Grisham novel at your local bookstore, you can give that copy to your friend without violating Mr. Grisham’s copyright. This doctrine has important caveats and restrictions; please consult an attorney for more information.

There are also specific “safe harbors” for users of copyrighted computer programs. First, a user may make a copy of a copyrighted computer program if copying the program is necessary for using the program with a computer or other machine that uses the program. *See* 17 USC § 117(a)(1). Second, a user can create a copy of a copyrighted computer program for the purposes of maintaining or repairing a computer or other machine that uses the program. *See* 17 USC § 117(c)–(d). Please see the subsection “Copyrights and the Internet” for a discussion on safe harbor legislation for Internet Service Providers (“ISP’s”).

Registration

Registering your original work with the federal Copyright Office is not necessary to gain copyright protection. As stated above, you must simply fix your original work into a tangible medium of expression. Registering your work with the Copyright Office does, however, confer some significant benefits, some of which include:

- 1) Registration provides nation-wide constructive notice of the facts and expression of the copyrighted work (17 USC § 205);
- 2) Courts will take registration as prima facie evidence of the copyright's validity (17 USC § 410(c));
- 3) Registration is necessary for recovering statutory damages and attorneys' fees in an infringement action (you can elect between regular monetary damages or have the court assess the appropriate amount of damages as dictated by statute) (17 USC § 412); and
- 4) Registration is necessary for bringing a vicarious liability or contributory liability claim against any third parties (17 USC § 412).

The main disadvantage of registering a copyright can be that the work becomes public. This matters when you would otherwise have "trade secret" protection over the original work. You are entitled to trade secret protection over your intellectual property only if that intellectual property is not made publically available. Registering a copyright or "prosecuting" a patent application makes the matter public, and, therefore, means that trade secret protection will be lost. For more information, please read the "Trade Secrets" section, below.

For more information regarding registering your original work, please consult an intellectual property attorney and visit www.copyright.gov.eco.index.html.

Copyrights and the Internet

The DMCA, as introduced above, has been a legislative attempt to make copyright laws conform to the ever-changing landscape of Internet communication and E-commerce businesses. Although the DMCA has implemented various changes, this guide will discuss only two developments.

First, the DMCA codified certain "anti-circumvention prohibitions" to impose liability on creators of technology that circumvents technological measures that would otherwise protect a copyrighted work. *See* 17 USC § 1201–05. The classic example is that of a computer program that scrambles a copyrighted song in MP3 format, transmits the scrambled bits of information to a user, and then reassembles the information into the original format.

Second, the DMCA codified certain safe harbors for ISP's. The idea here is that an ISP should not be held liable for copyright infringement when it has no knowledge of its customer's infringing activities. *See* 17 USC § 512. In order to take advantage of this safe harbor, however, the ISP must implement mechanisms through which a copyright holder can identify the alleged infringers.

Please consult an intellectual property attorney for more information on the DMCA.

Summary

The important thing to remember about copyright protection is that it extends only to the expression of your idea, and not to the idea itself. If you are writing software code, for instance, copyright law can prevent others from using the exact same code sequence, but cannot prevent them from making a similar program. In order to protect your ideas, you must turn to patent or trade secret law.

Patents

Definition and Background

Patent law gives you intellectual property protection unlike any other area of law. With patent protection, you acquire a "property right" in your invention. There are three types of patents: 1) utility patents (35 USC § 101) (defined as any "new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof"); 2) design patents (35 USC § 171) (defined as a "new, original, and ornamental design for an article of manufacture"); and 3) plant patents (35 USC § 161) (defined as "any distinct and new variety of plant, including cultivated sports, mutants, hybrids, and newly found seedlings").

A property right means that you own the idea of the invention itself. Just as you can keep others from trespassing on your real property, you can keep others from copying or using your idea. With copyright protection, you own your particular expression of an idea. For instance, you may have copyright protection over the source code of your software program, but you could not prevent another programmer from writing a different program that accomplishes the exact same function. With patent law, however, you can prevent others from copying your idea.

To give another example, trade secret protection allows you to sue others for unlawfully stealing your idea, but does not protect you against a competitor reverse engineering your trade secret. The recipe to Coca-Cola is a trade secret, and if someone reverse engineered the recipe, they could lawfully sell cola products with the same recipe. A patent, however, gives you the right to stop anyone from using your invention, even if they independently re-invented it or reverse engineered it.

The other major difference between patent law and other types of intellectual property protection is that patent protection requires the inventor to apply for intellectual property rights.

With trademark law, you merely have to use the mark; with copyright law, you merely have to fix the work in a tangible medium of expression; and with trade secret law, you merely have to have a secret that gives you an economic advantage. For patent protection, however, you must “prosecute” your invention in the USPTO in order to acquire a patent right. Please note that the process of filing and attempting to have your patent granted by the USPTO is referred to as “prosecuting” a patent application.

Patent protection can last for either fourteen (14) years from the grant date for design patents (35 USC § 173) or twenty (20) years from the grant date for utility patents (35 USC § 154(a)(2)). The patent will be granted to the first “inventor” of the invention, or person to whom the invention was assigned. 35 USC § 116–118. This can become tricky when someone has been the first to invent something, and has kept it secret; but, a later inventor independently invents the same thing, and immediately files a patent application for it, beating the first inventor to the USPTO. *See* 35 USC § 102(g).

As a business owner, you should also be mindful of determining whether your employee’s inventions are your intellectual property or theirs. This largely turns on whether the employees made the invention in the scope of their job performance. Please see an intellectual property or employment law attorney for help with these issues.

Patent Rights and Infringement

As stated above, a patent gives you a property right over your invention. You have the right to prevent others from “making, using, selling, or offering to sell an infringing product in the United States.” 35 USC § 271(a). This also means you can license these rights, exclusively or nonexclusively.

An “infringing product” is ordinarily one that is a literal copy of your patented invention. An infringing product can also be a product that has changed minor details of your patented invention, but has retained its essential identity. In such cases of “equivalent” inventions, you can bring an infringement action pursuant to the “Doctrine of Equivalents.” To do so, you must prove that the infringing product 1) performs substantially the same function as your invention, 2) in substantially the same way as your product, and 3) achieves the same result as your product. *See Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 535 U.S. 722 (2002).

The Doctrine of Equivalents is not always available as the defendant can assert a defense under the “Doctrine of Prosecutorial History Estoppel.” This doctrine has to do with whether you made concessions during the patent application process. The essential idea is that if you made an amendment to your patent application while prosecuting the patent, the law will presume you had to narrow your claims or elements in order to achieve patentability. If your invention’s claims or elements had to be narrowed to achieve patentability, then it does not make sense to broaden your patent’s protection through the Doctrine of Equivalents. *See generally Festo*.

For more information on whether you have an actionable patent infringement case, please consult an intellectual property attorney.

Patent Application Process

The biggest benefit to a patent is that it is the strongest form of intellectual property protection. The biggest drawback, however, is the lengthy, complicated, and often expensive process of obtaining a patent. A patent can be prosecuted by only two categories of individuals: 1) the inventor himself/herself, or 2) a licensed patent attorney. On the one hand, it can be far less expensive to prosecute a patent yourself. Please see the following websites for more information: <http://www.uspto.gov/patents/index.jsp> (PTO's main website regarding patents); <http://www.uspto.gov/patents/process/index.jsp> (PTO's outline for patent application procedures); and <http://www.uspto.gov/patents/resources/index.jsp> (Guides and tools for prosecuting a patent). On the other hand, a licensed patent attorney can greatly aid you in ensuring that your patent is granted, and in drafting your application in such a way to reduce the risk of later infringers claiming that the patent was improperly granted.

The content of the patent application will depend on the kind of patent you are seeking. For instance, utility patent applications must contain one or more "claims" that embody a written list of "elements" defining the scope and application of the invention. For design patents, a single claim is usually all that is required, along with a drawing of the invention.

The patent application process usually takes a number of years. But, if your invention is sufficiently important to public health, national security, or the environment, you can file a "petition to make special," which will accelerate the review date if granted. *See generally* <http://www.uspto.gov/patents/process/file/accelerated/index.jsp>. You can also file a "provisional patent application" within one year before filing the regular patent application. *See generally* <http://www.uspto.gov/patents/resources/types/provapp.jsp>. The provisional application can be beneficial in "priority contests" between and among inventors because it gives you an earlier filing date.

If you want a "foreign" or "international" patent over an invention you made in the U.S., you must first attain a U.S. patent. *See* 35 USC § 119. When considering whether to apply for a foreign patent, please keep in mind that foreign patent law can be stricter than U.S. patent law with regard to the secrecy—or "novelty"—of the invention prior to filing the application. This topic will be discussed in "Patentability Requirements," below.

Once you are granted a U.S. patent, you must quickly decide whether to file for a foreign patent as the Paris Convention for the Protection of Intellectual Property ("Paris Convention") gives you a one year grace period to file an application. The application process can be simplified by using one application for the different member countries pursuant to the European Patent Convention ("EPC"). *See generally* <http://www.epo.org/patents/Grant-procedure.html> (EPC website regarding patent application procedures). Please consult an attorney who specializes in international patent law for more information.

Patentability Requirements

The USPTO will grant a patent if five requirements are met: 1) the invention must be “novel;” 2) the invention must not be “obvious” to a person of ordinary skill in the relevant field; 3) the invention must be “useful” (if a utility patent); 4) the invention must be of the proper subject matter; and 5) the patent application must be “enabling” to a person of ordinary skill in the relevant field. This guide will briefly address the meaning of each requirement.

1) Novelty

The requirement of novelty for a patent does not mean the invention must have been recently invented. Indeed, inventors have been known to suppress their inventions for years before filing a patent application. The general rule is that a patent will not be granted if 1) the invention was known of or used by others in the U.S. prior to the invention by the applicant, 2) the invention was patented or described in a printed publication anywhere in the world prior to the invention date by the applicant, or 3) the invention was in “public use” or on sale in this country more than one (1) year prior to the date of application. *See* 35 USC § 102. The boundaries of these requirements can be tricky, especially with regard to whether an invention was “published” or put into “public use.” As alluded to above, the U.S. novelty requirement is far more lenient than foreign novelty requirements: most foreign countries do not provide the one (1) year grace period of 35 USC § 102. In other words, a patent put into public use at any time before filing a patent application will not be considered novel.

Novelty is assessed by looking at the “prior art.” Determining what is the prior art for a given invention can often be the source of contention, particularly in litigation. Prior art is essentially the scientific or technical field from which an invention came. Novelty is usually not a difficult threshold to meet as a patent applicant need have only one element that is different from any other single invention in the prior art. In other words, an invention fails this requirement only if it is entirely anticipated by one single prior invention. Even if you change one little element on a prior invention, you have a “novel” invention. This is an important contrast to the “nonobviousness” requirement, below, where various elements of different inventions can combine to make your invention “obvious,” and, thus, not patentable. So, one little change might make your invention novel, but that change could be entirely obvious.

2) Nonobviousness

An invention will not be granted a patent if the invention would have been obvious and predictable to a person having ordinary skill in the prior art (otherwise known as the “Phosita,” an acronym for “person having ordinary skill in the art”). *See* 35 USC § 103. The general rule of thumb is that a patent will not be granted if, by combining commonly-used elements within the prior art without changing their essential functions, the new invention and its function are predictable.

Not surprisingly, the nonobviousness requirement is often the trickiest part of a patent application. This is because everything in the prior art must be considered, and the PTO has the unenviable task of figuring out in hindsight whether a now-existing invention was previously not predictable and obvious prior to its invention.

In an infringement action where the defendant asserts the affirmative defense that the patent is invalid because the invention was obvious, courts are forced to analyze the obviousness of the invention. The courts have developed a three-phase analysis to help determine whether an invention was obvious: 1) the scope and content of the prior art must be identified; 2) the differences, if any, between the invention and the prior art must be identified; and 3) the level of skill of the relevant Phosita must be identified. *See generally KSR Int'l Co. v. Teleflex, Inc.*, 550 U.S. 398 (2007).

When courts engage in this inquiry, they can resort to “secondary considerations” that are objectively ascertainable signals of whether the invention was obvious. There are several secondary considerations, some of which include:

- A) Commercial success. The idea here is that if the invention is a commercial success, then it is more likely to be nonobvious because the patent holder’s competitors would have already created and sold the invention.
- B) Recognition and acceptance by competitors. The idea here is similar to above: if the patent holder’s competitors in the relevant industry recognize the invention as nonobvious, then it is more likely to be so.
- C) Whether the invention met a long-felt need. The idea here is that if the invention was obvious, the need would have already been met.
- D) Whether others tried and failed. The idea here is that if the patent holder can show that others had tried to invent the product, but were unable to do so, it is more likely to be a nonobvious invention.

Courts historically have relied on these secondary considerations when making a determination of nonobviousness because they are more easily ascertainable than figuring out the differences between the invention and the prior art.

3) Usefulness

Usefulness applies to “utility” patents, as opposed to design patents. This requirement is fairly simple: the invention must actually work. *See* 35 USC § 101. A classic example of a patent that is not useful is a perpetual motion machine, because such an invention is impossible as it would violate the second law of thermodynamics.

4) Proper Subject Matter

As described above, there are only three types of patents: 1) utility patents, 2) design patents, and 3) plant patents. The proper subject matter requirement imposes restrictions on what can be patented. The general rule is that a patent will not be granted for laws of nature, natural phenomena, algorithms, and mathematical principles and formulae. *See, e.g., Diamond v. Diehr*, 450 U.S. 175 (1981). To give a hyperbolic example, you could not patent ocean waves and charge surfers a licensing fee every time they ride one. Nor could prominent Princeton University professor Andrew Wiles patent his solution to Fermat's Last Theorem, which has stumped mathematicians for centuries.

Although mathematical algorithms cannot be patented, a current, live issue is the patentability of business methods/processes and/or software. The courts have allowed certain business methods and software programs to be patented, despite the fact that these products are typically embodied in a mathematical algorithm.

The law on this issue is quite complicated and unresolved. For instance, the Federal Circuit held that an algorithm is patentable "if it produces a useful, concrete, and tangible result." *State St. Bank & Trust Co. v. Signature Fin. Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998). Recently, however, the same court called this test into doubt, and held that a process is patentable if "(1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing." *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008). The *Bilski* case has been argued before the Supreme Court, but no opinion has been published as of this writing. Please consult an intellectual property attorney on these issues, especially as the law is certain to change significantly after the Supreme Court's decision is handed down.

5) Enablement

The requirement of enablement means that the application has to be drafted with sufficient clarity and specificity that a Phosita would be able to replicate your invention.

This requirement highlights the underlying rationale of patent protection: the law will grant you a property right in your invention for a limited duration in exchange for the complete disclosure of your invention to the public. After your patent expires, the invention inures to the public good. Compare this with trade secret law, where you can indefinitely retain ownership of your intellectual property, but you are not given nearly as much protection because you have kept your intellectual property a secret from the public.

Summary

The most important thing to remember about patent is that it is arguably the strongest, yet most expensive, form of intellectual property protection available. With such protection, however, comes the obligation to make your invention public. And after your patent expires, you will no longer be able to prevent others from making, using, and selling your invention. In

order to weigh your intellectual property protection options fully, please consult an intellectual property attorney.

Trade Secrets

Definition and Background

A trade secret is information that can be used in the operation of a business that is sufficiently valuable to afford an economic advantage over your competitors. Simply put, trade secret law protects your company's inventions and other valuable information (such as client/customer lists) that is valuable because of its secrecy. As a legal and practical requirement, this information must be kept relatively secret, because it would lose its economic value if it became publically known.

A trade secret does not need to be kept absolutely secret. For instance, you are allowed to disclose trade secrets to your employees, independent contractors, or even other companies, provided that you limit such disclosures and enforce them with a properly drafted nondisclosure agreement.

Trade secret protection is similar to trademark protection insofar as the onus is on you to protect your intellectual property. With trade secrets, if you do not take reasonable measures to safeguard your intellectual property, you will lose your legal rights. For instance, you can lose trade secret protection if you do not have proper employee policies and procedures regarding trade secret protection. Such policies are necessary for both current and former employees. You should make sure to consult an intellectual property or employment law attorney to make sure your policies and procedures are sufficiently robust and legally enforceable in your state.

Differences between Trade Secrets and Patents

Many entrepreneurs will face the decision between choosing trade secret or patent protection for their invention. What follows is a brief summary of the differences.

1) Secrecy.

Trade secret protection depends on the economic advantage of your invention. By definition, the invention must be kept secret. A patent, however, must be publically disclosed. As discussed above, the underlying idea of patent protection is an exchange of benefits: the patent holder has the exclusive property right over its invention for a limited amount of time in exchange for giving the invention over to the public trust after such time as the patent expires.

2) Duration.

Trade secret protection will last indefinitely, at least until the information becomes public knowledge. Patent protection lasts only for a predetermined amount of time, depending on the kind

of patent granted. After that, you can no longer prevent others from making, using, or selling your invention.

3) Protection.

Trade secret protection does not give you a property right, it merely gives you the right to prevent others from acquiring your trade secret via unlawful means. In other words, a competitor can lawfully reverse engineer your trade secret and use that information to its economic advantage. With a patent, no one but the holder can use the invention, regardless of how it is discovered or acquired.

4) Expense/Time in Acquiring the Right.

Trade secret protection is relatively inexpensive as it simply springs into existence as long as you have kept your invention secret and that is something from which you derive economic value. Patents, on the other hand, can be incredibly time consuming and expensive to obtain. A patent application can take years to push through the USPTO, and can cost you thousands of dollars in legal fees.

Please note that you must publicly disclose your invention in order to patent it, and, as a result, you will lose any trade secret rights you may have. This means that the choice between trade secret and patent protection is usually one of mutual exclusion. Furthermore, some patentable subject matter can also be copyrighted. Again, a copyright gives you protection over the expression, not the idea. Furthermore, if you federally register a copyrighted work, this also generally entails a full public disclosure, thereby vitiating any trade secret rights. Please consult an intellectual property attorney to help determine what type of intellectual property protection is best for your business's intellectual property inventory.

Summary

Although not the strongest form of intellectual property protection available, trade secret law can potentially give an entrepreneur protection that will last into perpetuity. The dilemma most entrepreneurs will face is whether to maintain trade secret protection, or to opt for patent protection. The calculus an entrepreneur must run is essentially to determine what kind of protection will be the most lucrative in the long run. Fortunately, while you contemplate pursuing a patent, your invention can remain relatively protected by trade secret law in the meantime.

Conclusion

The foregoing hopefully provided you with a general, yet substantive, overview of intellectual property law and the types of intellectual property protection that are available. The appropriate form of protection for your given item of intellectual property will depend in large part on the nature and character of said item. For instance, trademark protection extends only to

marks, and not to ideas or inventions themselves. You and your business will face difficult decisions in deciding what forms of intellectual property protection to use, as each form of protection has its own advantages and disadvantages. Please consult an intellectual property attorney to determine 1) what is in your intellectual property inventory, and 2) how best to protect said inventory.

	How to Acquire Rights	What Can Be Protected	Nature of the Protection	Registration	Benefits of Registration	Drawbacks to this IP Right
Trademarks	Simply start using the mark in commerce to identify your goods or services.	Anything that identifies your goods/services: words, symbols, sounds, colors, overall schemes or “trade dress.”	Prevent others from using a confusingly similar mark or a mark that dilutes your mark’s effectiveness.	1) State registration available. 2) Federal registration available: www.uspto.gov/teas	Federal: 1) Nation-wide notice; and 2) litigation benefits (damages, jurisdiction, evidence of validity).	Does not protect inventions, ideas, or original works of authorship. Sometimes protects domain names.
Copyrights	Simply put your original work of authorship into a tangible medium of expression	Original works of authorship: books, music, software code, movies, etc. Cannot protect the underlying ideas.	Exclusive right to reproduce, distribute/perform/display, and create derivative works.	Federal registration available: www.copyright.gov/eco.index.html	1) Nation-wide notice and 2) litigation benefits (damages, evidence of validity, third party liability).	Only protects the expression of an idea, not the idea itself. Therefore, cannot protect inventions.
Patents	Must apply or “prosecute” a patent application: http://www.uspto.gov/patents/index.jsp	New and useful processes, machines, inventions, some designs, and new varieties of plants.	Have a “property right” in an idea: have the exclusive right to use/sell your invention.	Only form of IP protection that must be applied for: http://www.uspto.gov/patents/process/index.jsp	Gives you the “strongest” form of IP protection: the property right over an idea.	Patent will expire, and you will lose your property right; expensive and time-consuming to acquire.
Trade Secrets	Simply have and use valuable business information that is kept secret and gives you an economic advantage.	Anything that is secret and gives you an economic advantage: ideas, inventions, customers lists, etc.	Simply the right to prevent others from obtaining the secret unlawfully. Competitors can reverse engineer your trade secret.	N/A	N/A/, but a benefit of this protection is that it lasts as long as the information remains secret, unlike a patent which will expire.	Weak form of protection insofar as a competitor can use your trade secret if it is ever disclosed or re-invented through independent discovery.

Section 3: Remaining Issues

There are a number of other highly important issues that you must consider as an entrepreneur and emerging business owner. Although no legal guide can possibly cover them all—as your particular situation will always dictate what issues you will encounter—this section of the guide is intended to give you a general overview of some important areas of inquiry for your emerging business. The areas treated herein include 1) employment issues, 2) business financing, and 3) insurance issues.

Because these topics are extremely complicated and the law regarding them can vary widely depending on your state and particular situation, this guide will only be able to highlight several, important issues for each area. As always, please consult an attorney for more discussion on these issues, and for a thorough review of all the legal issues that your business faces.

Employment Issues

As an entrepreneur starting your business, you must be careful how you go about hiring, managing, and, if necessary, terminating employees and independent contractors. Both federal and state laws regulate the increasingly complicated relationship between employers and employees.

Because hiring will probably be the first employment related activity in which you will engage, you must be mindful of the proper methods and procedures. For instance, you must ensure that you do not ask any non-job-related questions that touch upon problematic topics such as race, religion, ancestry, disability, age, or anything sex related. *See, e.g.*, Title VII of the Civil Rights Act of 1964 at 42 USC § 2000e (hiring protections for minority and female applicants); www.dfeh.ca.gov (website regarding allowed and disallowed areas of inquiry when hiring in the state of California). For instance, do not ask a female applicant whether she plans on getting pregnant any time soon.

You must also be mindful in the hiring process that you do not make any statements that could be reasonably construed by the applicant as a promise or guarantee of employment. This potentially exposes you to a lawsuit for, among other things, “promissory estoppel” or “detrimental reliance,” where the applicant will claim he/she relied upon your promise of employment to his/her detriment. Please consult an employment law attorney for more instruction on how to protect yourself during the hiring process.

You may also struggle with the choice between hiring employees or independent contractors. Hiring an independent contractor can be attractive because they work on a contract basis (i.e. they perform a discrete task pursuant to a contract and are then done when the contract performance terms are fulfilled) and fewer burdensome employment regulations apply to independent contractors. There are significant disadvantages, though, as you have less control over independent contractors than employees, and you can face significant tax and legal penalties

if you misclassify an employee as an independent contractor. Additionally, you must be mindful that independent contractors, absent an agreement to the contrary, will own all of the intellectual property rights over any work they perform on your behalf. These are complicated and extremely important matters for your business, and it would behoove you greatly to consult an employment law attorney.

Whether you hire employees or independent contractors, you must also have strong agreements in place that protect your intellectual property. Such agreements provide not only for the assignment of such rights, but also for the nondisclosure of any “trade secrets.”

You should also consult an attorney to help determine the content and character of your employee policies and employee handbook. Such documents are usually highly advisable, and must be drafted carefully as they will define your relationship with your employees. One thing to be drafted carefully is any policy or procedure regarding discipline or termination. This is because sloppy drafting can vitiate the general presumption of “employment at will.” Essentially, if you say, write, or intimate anything to an employee that raises a reasonable expectation they cannot be terminated at will for any reason, you are bound to such a reasonable expectation. You must be careful because any oral statements or terms in an employment policy that confer an expectation of continued employment can trump any contrary terms in the employment contract. Consulting an employment law attorney can help you retain control over your workforce, while at the same time providing your employees with clear rights and guidelines. This will ensure a cleaner and smoother working relationship.

Business Financing

Unless you are going to fund your emerging business with your personal funds, you will need to seek outside financing at some point during your business’s development. There are various reasons for or milestones upon which you may seek financing: the start-up of your company; your company’s development stage; or your company’s expansion and growth phases. The type of financing you will be seeking depends on your risk preferences, your company’s history, as well as the reason for needing the funds. Typical sources of financing include: 1) yourself; 2) your friends and/or family; 3) “angel” investors (wealthy individuals who are seeking high returns on a relatively high risk venture); 4) “venture capital” investors (usually private firms who seek high returns via significant financing and management control); and 5) government programs (e.g. the Small Business Administration (“SBA”) at www.sba.gov). Venture capital financing is often considered the holy grail of emerging businesses as “VC” firms can provide significant capital infusion. The downside to VC financing, however, is that such firms can take a heavy-handed approach to their involvement with your business’s management and development. This makes sense as they want to protect their considerable investment.

Regardless of the source of financing, you should approach a financing transaction with diligence and great attention. Some key issues include: 1) the proportion of debt to equity financing that will result from the transaction; 2) the realistic expected return from the financing;

3) whether and in what form the financing party will be involved in your company (i.e. how and whether management will be changed by the transaction); and 3) the impact of equity financing on any present ownership interests (e.g. whether a venture capital investor will dilute your ownership interest).

A crucial step in sorting out these issues and attracting investors is to prepare a business plan. Even if you are not currently seeking outside financing, a well thought-out business plan can focus your attention on your business's goals, strategies, milestones, and management structure. *See generally* www.sba.gov (website for the SBA with helpful tools and guides for small and/or emerging businesses).

When developing a business plan and/or seeking outside financing, you should consult a business law attorney who can help you attract sources of financing. After you have found financing, an attorney can aid you in structuring the transaction to protect your interest in your company.

Insurance Issues

Broadly speaking, there are essentially two kinds of insurance policies: 1) first party policies which cover claims and losses by you as the insured; and 2) third party policies which cover claims and losses by third parties against you as the insured. It is highly advisable for most businesses to obtain a type of third party policy known as a commercial general liability (“CGL”) policy. Such policies will insure you against losses up to a given amount, and obligate the insurance company 1) to indemnify you, and 2) to defend you. Please note that the insurance company usually has a duty to defend you even if it believes that it does not have to indemnify you because the claimed loss is outside of the CGL policy's coverage.

Because CGL policies cover losses only up to a certain amount (the “policy limit”), you may consider purchasing an excess or “umbrella” policy to indemnify you when either the losses are greater than your CGL policy limit or your CGL policy does not cover the given loss. You must also be sure to determine whether your business's insurance policies are “occurrence made” (policy covers injuries that occur while the policy is in existence, even if the claim is made after the policy has expired) or “claims made” (policy covers claims made only while the policy is in existence, regardless of when the injury occurred).

If you plan on conducting any of your business online, please note that standard CGL policies often do not provide adequate insurance coverage. As an online entrepreneur, you should determine whether your policy covers or you can purchase “riders” that will cover losses such as: 1) liability for business interruption and/or lost data; 2) liability for breach of privacy and/or other non-physical torts such as defamation; 3) liability for passing viruses and the like; and 4) liability for infringing another's intellectual property.

Another important line of defense if you conduct business online is to have a comprehensive and enforceable “terms of use” and “privacy policy” on your website.

Enforceability is a hot-button issue as electronic contracting is a relatively new development, and you must be sure you have proper online procedures in place to ensure your business enters into legally enforceable contracts with its customers. Please consult an Internet attorney to learn how to structure these and other e-contracts in such a way to make them enforceable.

You will probably have to purchase other forms of insurance for your business such as property insurance and errors and omissions (“E&O”) insurance. You will also need to comply with all relevant laws for unemployment compensation, disability insurance, and worker’s compensation. Unlike normal insurance, these forms of “insurance” are usually compulsory. It is advisable to contact an attorney and an insurance agent with experience in your industry to determine what types of insurance coverage are best for you and your business.

Conclusion

Whether you have yet to start your business or it is currently growing, this guide has hopefully provided you with useful, background information that every entrepreneur and business owner should know. The guide has endeavored to provide you the information you need to know now, in order to start your research or to initiate discussions with your attorney. This guide has attempted to provide helpful examples or the reasons and policies behind certain legal doctrines. The goal of such didactic measures is to give you deeper understanding of the issues at stake and how they play out on a practical level.

Please note that this legal guide cannot possibly cover all of the legal issues you will need to be aware of as an entrepreneur and emerging business owner. All this legal guide can do is touch upon the major areas of law you will initially encounter. You must seek legal counsel to attain a comprehensive review of all the legal issues your business has or will encounter.

As said many times already, please do not use this guide as a substitute for actual legal advice from a licensed attorney. This guide is merely to get you “up to speed” with your attorney, so that the two of you can have a productive dialogue about your particular issues.

You should be proud of what you have already accomplished as an entrepreneur. The author of this legal guide is honored to be of assistance to entrepreneurs and business owners such as yourself.