Strategic Alliances and the Management of Intellectual Properties: The Art of the Contract

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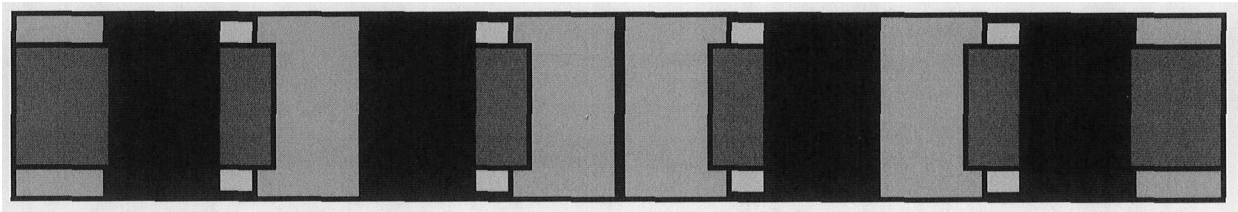

Introduction

Intellectual properties (IPs) have been identified as comprising approximately 85% of the overall economic value of a corporation (Smith and Parr, 2000). As represented by patents, trade secrets, copyrights, and trademarks, IPs constitutes a strategic resource that can assist organizations in the development of core competencies and sustainable competitive advantage (Mason, 2003; Fitzpatrick and DiLullo, 2004). Models of knowledge management have documented the evolutionary manner in which organizations have developed and strategically exploited IPs. During much of the last century, IP development was often the province of large vertically integrated firms. Vertical integration permitted many firms to capitalize upon their extensive resources, exploit value chain control/synergies, and utilize government enforced patent-trademark-copyright laws to develop, market, and protect intellectual properties (Chesbrough, 2004; Fitzpatrick and DiLullo, 2004). However, the strategic viability of these vertically integrated models of IP management began to decline due to the combined effects of reverse engineering and the rapid erosion of product and technology life cycles (Cringley and Sen, 1996). Organizations have responded by introducing new models of IP management that rely on the extensive use of strategic alliances and partnerships to facilitate the more rapid creation and commercialization of intellectual properties (Johnston and Lawrence, 1988; Rackham, Freidman and Ruff, 1996; Chesbrough, 2004; Fitzpatrick and DiLullo, 2004).

Despite these advantages, IP-based strategic alliances and partnerships are subject to a number of control, security, and anti-trust issues arising from interorganizational sharing, development, ownership, and exploitation of intellectual properties (Anthony, 2000; Saunders, 2003; Boni, 1999; Fitzpatrick and Burke, 2003). This paper discusses these knowledge management issues and their mitigation through effective partner screening, contracting, and partnership administration activities. A model highlighting these activities and their relevance for managing IPs across organizational boundaries is also presented.

Establishing IP-Based Organizational Alliances

Types of IP-based strategic alliances and partnerships

Outsourcing/subcontracting, R &D teaming and R & D joint ventures are popular methodologies that permit partnering organizations to harness, exchange, or synergistically develop IPs to achieve competitive objectives (Dickerson, 1998; Grover, 1995; Rackham et al, 1996). The firm initiating these partnering methodologies is often classified as a HUB organization (Dickerson, 1998; Fitzpatrick and DiLullo, 2004). HUBs seek out subcontractors or other business partners to secure access to strategic capabilities they lack. To manage these partnering relationships, HUBs assume the responsibility for developing all the administrative infrastructures needed to coordinate the exchanges of IPs among members of their partner cadre (Dickerson, 1998; Fitzpatrick and Burke, 2000).

When engaged in outsourcing, HUBs transfer their IPs to partners with the expectation that cadre members will utilize their own unique

capabilities to refine, produce, distribute, or market the transformed IP (Buono, 1997). IP transfers to R & D teams are generally implemented when HUBs wish to use the capabilities of the partner cadre to develop new products or technologies based upon proprietary knowledge contained in IPs contributed by the HUB. R & D joint ventures are a form of relational partnering. In this partnership form, HUBs and their partner cadre mutually contribute proprietary knowledge or trade secrets and other strategic capabilities to the partnership to create and competitively exploit new or jointly owned IPs (Rackham et al., 1996).

Knowledge management issues in IP-based alliances and partnerships

A key knowledge management issue confronting these types of partnerships is the degree to which cadre members can selectively protect and use contributed or jointly developed IPs to achieve competitive advantage. For example, when using both outsourcing and R & D teaming, HUBs organize partner cadres to perform "work-for-hire" (Fitzpatrick and DiLullo, 2004). Under work-for-hire, HUBs retain exclusive ownership of work product developed or derived from their original IP contributions (U.S. Copyright Law, 1976). However, despite these ownership rights, HUBs must take active steps to (1) protect their intellectual properties and trade secrets from being disclosed to potential competitors by the current or former employees of business partners (Fitzpatrick and DiLullo, 2004; *Speech Technology Associates v. Adaptive Communications, Inc. et al,* 1994)), and (2) safeguard these intellectual properties from being used in subsequent competitive endeavors by partners or subcontractors (*Yeti by Molly, Ltd.& Molly Strong-Butts V. Deckers Outdoor Corporation*, 2001; *Auto Channel, Inc. et al v. Speedvision Network, LLC*, 2001). Participants in R & D joint ventures must confront two additional knowledge management issues: (a) protecting and resolving ownership rights surrounding jointly developed intellectual properties; and (b) complying with federal antitrust regulations (Saunders, 2003).

Confronting these IP-knowledge management issues requires HUB organizations to create and administer a partnership model or system that permits them to effectively manage the potential competitive risks and legal liabilities associated with the use of intellectual properties by members of their partner cadre (Boni, 1999; Martinez de Andina, Tate, and Maddry, 2004; Miller, 1989; Cheeseman, 2004). Figure 1 illustrates a model that may help HUBs confront these competitive issues.

A Contract-Based Model of Intellectual Property Management

The model proposes that many of the aforementioned strategic control issues associated with IP origination and sharing in strategic alliances can be managed through effective partner screening, pre-partnership negotiations, partnership structuring activities, contract administration, and the monitoring of alliance partners after contract termination.

Partner identification and screening

The model suggests that partner identification and screening activities should largely be

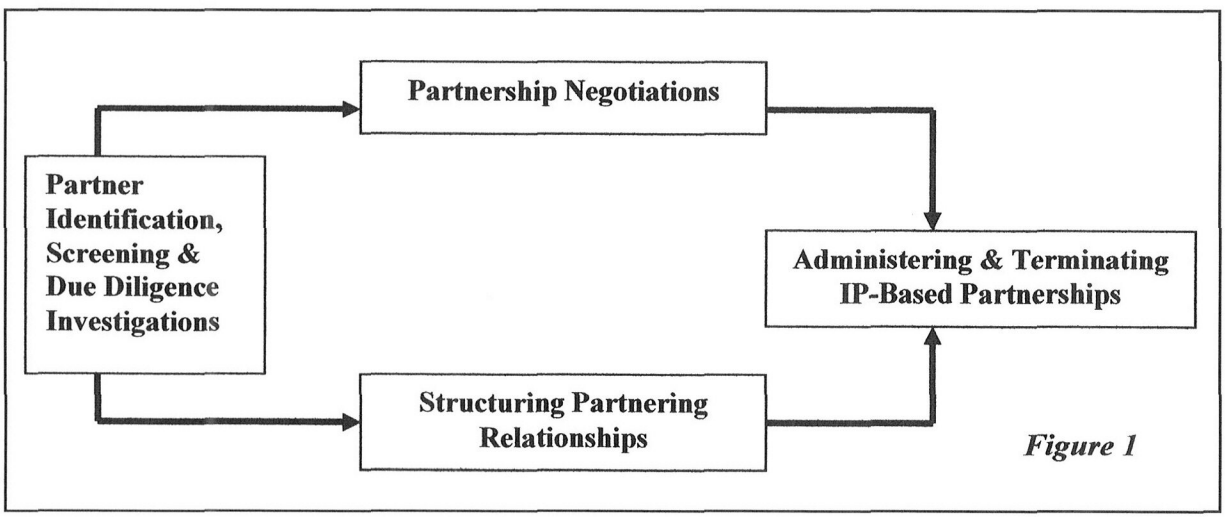

Figure 1

oriented toward a due diligence analysis. In due diligence analysis, HUBs must perform a detailed assessment of the potential partner's trade secrets, patents, and copyrights to determine the degree to which the partner controls or has access to IPs that (a) can add competitive value or synergy to a HUB's business activities (Rackham et al, 1996; Martinez de Andina, et al, 2004), and (b) are truly proprietary (Martinez de Andina, et al, 2004). For example, when acting as organizational HUBs, both Hewlett-Packard and Boeing carefully screened the strategic capabilities of their business partners to determine if these capabilities would permit them to rapidly commercialize products with innovative technologies. This partner screening assessment permitted Hewlett-Packard to conclude that in launching its family of laser printers, they could enter the market faster by (1) contracting with Cannon to produce printer engines, and (2) use their own expertise to develop software linking the computer applications of other developers to their LaserJet product line (Zachary, 1992). Similarly, in developing the 777 aircraft, Boeing created design/build teams comprising of a variety of manufacturers and outsourcers. To staff these teams, Boeing analyzed the unique trade secrets and strategic capabilities of these potential business partners to discern which possessed unique IPs, strategic capabilities, or competitive synergies that could be harnessed to rapidly design, efficiently produce, and sell the 777 to the aviation industry. Once again, these types of partner screening activities served to reduce the time between product conceptualization and commercialization ((Sabbagh, 1993).

To preserve and enhance competitive advantage in IP-based strategic alliances, HUBs must also discern the degree to which potential business partners possess knowledge, trade secrets, or other IPs that are truly proprietary (Martinez de Andina et al, 2004). In performing this type of due diligence, HUBs should access patent data bases (e.g., www.Delphion.com) to verify that a partner's trade secrets and pending patent applications are not infringing on the patents of other firms (Martinez de Andina et al, 2004). A review of partner and competitor patents may also permit the HUB to discern the degree to which it can better achieve competitive advantage or synergy by forming an IP-based strategic alliance with the potential partner or one of the potential partner's market competitors with similar proprietary knowledge or technologies. Additionally, HUBs should also review IP/patent licensing agreements that potential partners have originated with other firms to document possible restrictions and litigation risks associated with the use of IPs jointly controlled by the prospective business partner, other firms, or individuals (Tanenbaum, 1997).

Due diligence must also evaluate the degree to which a potential partner has (1) an adequate corporate security infrastructure that protects IP exchanges among members of the partner cadre, and (2) a litigation history free of law suits or legal complaints stemming from trade secret misappropriation, patent infringement, and breach of licensing agreements (Martinez de Andina et al, 2004). Evaluation of corporate security infrastructures is generally accomplished by physical inspection and auditing of partner facilities and security protocols (Boni, 1999; Fitzpatrick and Burke, 2003; Martinez de Andina, et al, 2004). This evaluation should focus on the degree to which partner security protocols adequately safeguard IPs through employee background investigations, employee nondisclosure or noncompete agreements, restriction of IP access to selected personnel, and deployment of physical or electronic security devices (Boni, 1999; Fitzpatrick and Burke, 2003; Uniform Trade Secrets Act, 1985). The partner's litigation history indicates both its reliability as a potential business associate and the degree to which it may expose the HUB to potential law suits should the IPs constrained by current patent and licensing agreements be illicitly utilized (Martinez de Andina et al, 2004; Fitzpatrick and DiLullo, 2004). This component of the due diligence can be facilitated (a) by requiring the partner to completely disclose all pending litigation or complaints filed against it for inappropriate or illicit IP use (Martinez de Andina et al, 2004), (b) through use of the Lexis-Nexis legal data base to review the litigation history of the partner at both a state and federal level, and (c) by requiring the partner to provide a complete list of IPs that may be controlled through joint licensing agreements with other individuals or organizations (Martinez de Andina et al, 2004).

Structuring partnership negotiations

Both the Uniform Trade Secrets Act (1985) and a variety of court cases indicate the importance of requiring potential business partners to sign nondisclosure and noncompete agreements prior

to exchanging proprietary information (Fitzpatrick and DiLullo, 2004). These types of documents serve to regulate the manner in which IPs disclosed in negotiations can be protected and secured for collective competitive advantage (Clarkson, Miller, Jentz and Cross, 2004). Several recent court cases illustrate how the presence or absence of these types of agreements serve to (1) protect IPs during partnership negotiations, and (2) subsequently establish legal remedies should members of the partner cadre misappropriate the IP disclosed during these negotiations (*Yeti by Molly, Ltd. and Molly Strong-Butts V. Deckers Outdoor Corporation*, 2001; *Auto Channel, Inc. et al v. Speedvision Network, LLC*, 2001).

For example, in *Auto Channel, Inc. v. Speedvision Network, LLC (2001)*, management of the Auto Channel attempted to interest other media organizations in participating in an alliance to produce and broadcast television programming dealing with automotive vehicles. To interest potential partners, the Auto Channel distributed promotional materials providing sample programming footage and information on both their product concept and target market. After expressing interest in this programming format, Cox Communications entered into negotiations with Auto Channel representatives to learn more about their video product and discuss potential licensing arrangements. After extensive discussions, Cox Communications broke off negotiations with the Auto Channel and formed a joint venture with Comcast to produce programming based on Auto Channel concepts. The Auto Channel subsequently filed suit against these parties and sought damages for misappropriation of trade secrets. However, much to their dismay, the court ruled against the Auto Channel. In this decision, the court noted that the Auto Channel inadequately protected its trade secrets by failing to secure nondisclosure/noncompete agreements from potential partners prior to negotiations (*Auto Channel, Inc. et al v. Speedvision Network, LLC*, 2001). In contrast, the *Yeti by Molly* case illustrates how securing pre-negotiation nondisclosure agreements can protect trade secrets communicated during these discussions. In this case, Molly Strong-Butts attempted to interest Decker Outdoors Corporation in producing a winter boot based on her product prototype. After securing a nondisclosure agreement, Strong-Butts transferred product samples, raw materials, and supplier lists to Decker. Decker subsequently discontinued negotiations and independently developed its own product substitutes based on the Yeti prototype. When brought to trial, the court stated that evidence of a nondisclosure agreement prior to negotiations constituted reasonable protection of trade secrets by Strong-Butts. Therefore, the court held Decker liable for trade secret misappropriation (*Yeti by Molly, Ltd. and Molly Strong-Butts V. Deckers Outdoor Corporation*, 2001; Fitzpatrick and DiLullo, 2004).

Structuring, administering and terminating IP-based partnerships

In developing IP-based alliances, HUBs must devote significant attention to crafting contracts which serve to facilitate the transfer, use, origination and security of proprietary knowledge among partner cadres both during the alliance and in the post-partnership environment (Taylor, 2004). Several types of contracts have been identified as supporting these knowledge management issues or activities. They include (1) initial partnering agreements; (2) licensing and royalty agreements; and (3) nondisclosure/noncompete agreements (Taylor, 2004; Saunders, 2003).

- *Initial partnering agreements.* Initial partnering agreements define the nature of knowledge exchanges and ownership in IP-based partnerships. As noted, when initial partnering agreements define relationships among members of the partner cadre as "work-for-hire," HUBs retain ownership or control over all IPs developed during partnering activities (U.S. Copyright Law, 1976). However, when using joint ventures to develop and competitively exploit IPs, both patent law and licensing, royalty, and nondisclosure/noncompete agreements are the primary legal vehicles for regulating IP ownership and usage (Saunders, 2003; U.S. Patent Law, 2003). When new IPs are jointly developed and subsequently patented, U.S. Patent Law (2003) states that ownership rights are equally shared among all participants named in the patent application. Therefore, in the absence of any contractual prohibitions, parties named in the patent are free to use or license jointly patented IPs to others in subsequent competitive ventures (U.S. Patent Law, 2003).

- *Licensing and royalty agreements.* The courts have recognized the ability of firms to employ

licensing agreements to control the manner in which business partners can utilize proprietary knowledge and patented technologies shared with them by HUB organizations. This was exemplified by a case involving Monsanto's use of these types of agreements to govern the use of its licensed technologies by business partners. In *Monsanto Company v. Mitchell Scruggs et al.* (2004), the court upheld the right of Monsanto to regulate the manner in which business partners could use surplus raw materials (i.e., bioengineered seed product) containing their proprietary technology in subsequent competitive activities *(Monsanto Company v. Mitchell Scruggs, Eddie Scruggs and Scruggs Family Farm Supply, 2004)*. Similarly, after obtaining a patent assignment from John Browning to manufacture the Model 1911 semi-automatic pistol, Colt sought to enhance its revenues by establishing partnerships with other firms to manufacture and sell the pistol. In attempting to penetrate the European market, they partnered with Fabrique National (FN) of Belgium. This partnership was based upon a licensing agreement that specified the royalty payments to be received by Colt and the markets to which FN might sell the Colt licensed pistol. Colt utilized licensing agreements to create additional revenue sources and establish market parameters that protected its competitive position (Johnson, 2005).

Licensing and royalty agreements can also be used to contractually restrict and reward firms for the use of their IPs in competitive activities both during and after termination of partnership activities. These agreements have traditionally been structured so as to compensate individuals or firms when the intellectual properties contained in patents are made available to others (Cheeseman, 2004). However, in many R & D teams and joint venture activities, the trade secrets exchanged between members of the partner cadre are used not only to develop new IPs but also to improve the effectiveness of current and future business operations. This practice is common among outsourcers that choose to affiliate with Japanese manufacturing HUBs. Often, these manufacturers (e.g., Motorola, Nissan, and Toyota) require their subcontractors to engage in compulsory process benchmarking activities in which trade secrets are exchanged among members of the outsourcer cadre so that they can collectively improve their effectiveness in service to the HUB organization (Dabholkar and Neeley, 1998). This exchange of proprietary information may enhance partner capabilities in subsequent competitive venues not covered by original partnership agreements (Miller, 1989; Fitzpatrick and DiLullo, 2004). Therefore, both Miller (1989) and Fitzpatrick and DiLullo (2004), propose that licensing and royalty agreements be structured so as to (1) restrict the manner in which IPs shared among the partner cadre can be used to enhance the current and future competitive activities of specific participants, and (2) compensate the originators of the IP for the "value" they have added to the partner's competitive activities.

The enforceability of these types of licensing and royalty agreements is largely contingent on the degree to which their restrictive covenants are compatible with antitrust laws (Saunders, 2003). Federal regulations propose that licensing, royalty, and other knowledge-sharing agreements may prove to be anticompetitive to the degree that they (a) pressure partners to curtail other R & D activities that would threaten or make obsolete asset investments by other members of the partner cadre, (b) encourage patent pooling or cross licensing agreements that inhibit other firms from having access to intellectual properties owned or developed by the partner cadre, (c) facilitate the exchange of information on how shared intellectual properties can be used to potentially coordinate the independent competitive activities of cadre members, and (d) create tying arrangements that restrict partners from using the proprietary knowledge or technologies of other firms or their own independently controlled patents and trade secrets as product substitutes for IPs owned or created by the partner cadre (Anthony, 2000; Saunders, 2003; Fitzpatrick and DiLullo, 2004). For example, the courts have generally considered tying arrangements or agreements to be a violation of anti-trust statues. This was illustrated in a recent case involving technology licensing in the printing industry (*Independent Ink, Inc. v. Trident, Inc., 2002*). In this case, Trident permitted other firms to license its patents for fabricating proprietary ink jet printing cartridges only if Trident ink was used in these cartridges. Furthermore, Trident would only honor product warranties if their own inks were used to fill or refill ink cartridges licensed and subsequently manufactured from their designs. Independent Ink, a licensee of Trident technologies, contended that the purchase of

Trident inks was linked to the right to manufacture ink cartridges based upon Trident's proprietary designs. By limiting their ability to acquire inks from other vendors, Independent Ink claimed that this product linkage was an illegal tying agreement and was, therefore, in restraint of trade. The U.S. District Court agreed with Independent Ink's claim and found Trident to be in violation of the Sherman Antitrust Act (Independent Ink, Inc. v. Trident, Inc. 2002).

• *Nondisclosure and noncompete agreements.* Nondisclosure and noncompete agreements are also recommended as contract vehicles for regulating the control or dissemination of IPs in partnering activities and post-partnership environments (Clarkson, et al, 2004; Fitzpatrick and DiLullo, 2004). Nondisclosure agreements have been used to facilitate the creation of corporate security infrastructures that target trade secret losses in partner cadres directly attributable to poor supervision of quality control, waste management, and inventory systems (Boni, 1999; Fitzpatrick and Burke, 2003). Nondisclosure agreements have also been used to curtail the loss of proprietary knowledge among partner cadres due to employee migration during or after expiration of partnership agreements. During partnering activities, personnel sometimes leave the employ of cadre members and subsequently use their knowledge of HUB trade secrets to develop product substitutes for competitors (*Speech Technology Associates et al v. Adaptive Communications Systems, Inc.* et al, 1994; Fitzpatrick and Burke, 2003). The courts have ruled that valid nondisclosure agreements can be used to enjoin migrating employees from sharing proprietary information with subsequent employers. This doctrine was exemplified in *Uncle B's Bakery, Inc. v. O'Rourke (1996)*. In this case the former manager of the Uncle B's (i.e., Kevin O'Rourke) went to work for another bakery. Mr. O'Rourke had extensive knowledge of trade secrets behind the recipes, manufacturing processes, and packaging systems that Uncle B's used to manufacture and sell frozen bagels. Its suit against Mr. O'Rourke and his subsequent employer, Uncle B's claimed that O'Rourke's new job would enable him to disclose or use trade secrets learned at Uncle B's. In deciding the case, the court ruled that nondisclosure agreements can be used to prevent former employees from using information gained as a result of prior employment to assist their new employers. Mr. O'Rourke was therefore enjoined from using knowledge of Uncle B's trade secrets and manufacturing processes to assist his new employer (*Uncle B'S Bakery, Inc. v. O'Rourke, 1996*).

To lessen the security vulnerabilities attributable to employee violation of partner nondisclosure/noncompete agreements, HUB organizations may wish to review the litigation history of potential partners against their current and former employees. The Lexis-Nexis legal research data base can be accessed to identify the frequency with which potential business partners have instituted legal action against employees for violation of nondisclosure/noncompete agreements. Should this survey reveal an extensive litigation history associated with violation of these agreements, HUBs might be well advised to seek other business partners.

Nondisclosure agreements do not inhibit former or current employees from assisting competitors in rediscovering trade secrets through a parallel process of development. This technique was used to assist competitors in duplicating the trade secrets contained in the Kodak 401 process (Fink, 2002). In this situation, current and former Kodak personnel were employed by competitors as consultants in their effort to reverse engineer the 401 process. In this consultant role, these current and former employees did not actually disclose Kodak trade secrets but guided competitor personnel through all the identical processes necessary to "re-discover" these trade secrets. Under these circumstances, competitors were able to independently "clone" these trade secrets, and Kodak employees were deemed not to be in "technical violation" of their nondisclosure agreements since proprietary information was not formally disclosed (Fitzpatrick, DiLullo and Burke, 2002; Fink, 2000). Therefore, it is strongly recommended that employees be required to sign both nondisclosure and noncompete agreements. In the Kodak situation, these latter agreements could have been structured to prohibit their employees from participating in parallel inventive processes and reverse engineering activities with competitors (Fitzpatrick, DiLullo and Burke, 2002). Absent a valid noncompete agreement, members of the partner cadre can also seek to limit IP disclosures of former employees by having courts enforce the doctrine of inevitable disclosure (*Pepsico, Inc. v. Redmond*, 1995). When applied by the courts, this doctrine

may restrict the time between termination of employment in the IP-based alliance and subsequent reemployment by competitors. This doctrine (a) recognizes that former employees may subconsciously utilize knowledge of a prior employer or partner's products or competitive operations when making decisions for subsequent employers, and (b) may restrict the migrating employee from working for competitors until such a time that their proprietary information is of limited competitive value (*Pepsico, Inc. v. Redmond, 1995*).

Conclusion

Strategic alliances or partnerships based on the exchange and collaborative development of intellectual properties have been identified as a business methodology for facilitating innovation and competitive advantage (Doz and Hamel, 1998). However, in formulating these IP-based collaborative alliances, members of partner cadres must ensure that their ownership of contributed or jointly created IPs is adequately protected from competitive abuse or compromise (Boni, 1999; Fitzpatrick and Burke, 2003). This paper has proposed that the safeguarding of IPs within these knowledge-based alliances can be managed through a variety of contractual agreements. These agreements regulate the manner in which IPs are transferred among and utilized by members of the partner cadre in current and subsequent competitive ventures. Contract-based IP alliances also provide their membership with specific legal remedies should these agreements be violated. However, the ultimate success of these IP-based alliances lies in the ethical behavior of the partners themselves (Fitzpatrick and DiLullo, 2004). Therefore, screening and due diligence investigations may represent the most critical components of the proposed IP-based partnering model by identifying potential business partners with not only the desired IP or creative capabilities but also a history of honoring their responsibilities with respect to the ethical use and protection of proprietary knowledge (Martinez de Andina, et al, 2004).

Dr. Fitzpatrick's teaching, management, consulting, and publishing focus on strategic planning and decision-making, competitive intelligence systems, corporate security management, organizational design, and general management. Attorney Samuel DiLullo teaches and researches in the areas of bankruptcy, contracts, and constitutional and intellectual property law.

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take advantage of this knowledge. The concepts and suggestions offered concerning how culture affects Web site design are archetypal in nature and do not include a specific course of action. Nevertheless, knowledge acquired in this area, when given the emphasis that it truly warrants, will significantly enhance the viability, vitality, and visibility of Web sites.

Dr. Cook, professor, speaker, author, and consultant, focuses on electronic commerce, information systems, and production/operations management in his numerous conference presentations and published articles. Myke Finlayson is an undergraduate pursuing a degree in management information systems.

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