The Trouble With Patent ‘Shop Rights’

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WITOUT REALIZING IT, businesses may share patent rights with their employees. Under the “shop rights” doctrine, absent an express agreement to the contrary, a company and its employee each may have rights to patented technology. This is particularly troubling to an acquirer desiring sole and exclusive rights to all intellectual property developed at a target company.

An employee’s rights to inventions can significantly impact a merger, acquisition, venture round or IPO. As intellectual property assets grow in significance, merger partners, venture capital investors and underwriters increasingly scrutinize those assets in due diligence. Accordingly, they require representations and warranties concerning the ownership of intellectual property (including patentable inventions) in almost every definitive agreement. In fact, these rights have become so important that many venture capital funds require their portfolio companies to enter into nondisclosure and intellectual property transfer agreements with all of their employees and consultants prior to venture funding.

In transactions that do not sign and close simultaneously, the acquirer’s obligation to acquire, or the investor’s obligation to invest, often is conditioned on the representations and warranties being true at the closing. This means that the investor, on the other hand, owns the patent rights and has the right to license the patent to others.

Moreover, the employee-inventor may be able to breach) required representations and warranties (relating to the “shop right” doctrine. For one, shop rights may preclude a company from providing (or cause the company to breach) required representations and warranties concerning the ownership of intellectual property. Moreover, the employee-inventor may be able to sell, license or assign her patent rights to a competitor. In the case of joint inventorship, each of the multiple inventing employees has an independent right to exploit the invention. This could mean numerous sources in the marketplace for the invention. A press release or another publicity surrounding a liquidity event, such as an IPO, venture deal or merger can easily precipitate a claim from a current or former employee-inventor who wants a piece of the “jackpot.”

A potential acquirer or investor also might be troubled by other ramifications of the shop rights doctrine. For one, shop rights may preclude a company from providing (or cause the company to breach) required representations and warranties concerning the ownership of intellectual property. Moreover, the employee-inventor may be able to sell, license or assign her patent rights to a competitor.

In essence, the “shop right” doctrine of patent law provides that absent (1) an employee’s written assignment of inventions to the employer, (2) the hiring of the employee for the specific purpose of inventing, or (3) the specific assigning of the employee to invent, the employer may at best have “shop rights” in the invention. This means that the company has only a non-exclusive, largely non-transferable right to use the invention, free of the requirement to pay royalties. The employee-inventor, on the other hand, owns the patent rights and has the right to license the patent to others.

One of the most potentially devastating aspects of the “shop right” doctrine is the limited transferability of the employee’s rights. Depending on the structure of the transaction, a sale of the company might extinguish whatever rights the company previously held. An acquirer would have to succeed to the entire business for those rights to be transferable. A merger or sale of all of the stock or assets of the business presumably would preserve the transferability of the shop rights, but anything less — for example, divesting a business unit — would make the transferability less certain.

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The truism that the employee-inventor’s bargaining power is greater just before or after an acquisition or IPO mitigates in favor of remedying these problems as early as possible.

At first glance, it may seem that a potential acquirer could address the issue of ownership of patent rights by careful and thorough due diligence in identifying key patentable inventions and their inventors. Such due diligence is necessary and may be helpful with respect to easily identifiable inventions. Given the newly sanctioned patentability of business methods, however, it is unlikely that an acquirer or even the target company can spot all of the patentable inventions used in the business. Accordingly, an acquirer cannot take complete comfort in due diligence alone. A more workable solution is obtaining written assignments from all employees.

Ownership of Patent Rights

An employee is presumed to own the patent rights in an invention he or she made in the course of employment, with certain exceptions (relating to the inventor’s explicit or implied assignment of the rights to the employer) and limitations (relating to the employee’s shop rights in the invention). The types of inventions which are potentially patentable encompass new, useful and nonobvious machines, products, compositions of matter, and processes, including business methods. By contrast, in copyrights, pursuant to the “work for hire” doctrine, an employer is presumed to be the owner of all copyrights in works made by an employee within the scope of employment.

Written Assignment

An assignment agreement covering all inventions made by the employee may give a company (and a potential acquirer) significant comfort regarding ownership of patent rights. The company also may benefit from provisions effective without any further action on the employee’s part and provisions requiring the employee to cooperate in assisting the company’s efforts to patent the invention. The company also may wish to include coverage of foreign rights in inventions, given that an assignment of United States patent rights does not necessarily assign counterparts in foreign countries.

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Under the ‘shop rights’ doctrine, absent an express agreement to the contrary, a company and its employee each may have rights to patented technology. This is particularly troubling to an acquirer desiring sole and exclusive rights to all intellectual property developed at a target company.
To avoid potential holes in ownership, a company should make certain that all employees sign these agreements. Failure to obtain agreements from all employees could leave an employer without rights or with severely limited rights to significant inventions. (Failure also can result in trying to chase down a non-signing former employee in order to close a significant business transaction.) Finally, it should be noted that some states (such as California) limit the content of assignment of inventions agreements. Thus it is imperative that a company inform itself of applicable state law prior to submitting assignment agreements to its employees. It also is imperative to obtain assignments from consultants, since neither copyright nor patent law provides automatic ownership rights in the work done by consultants.

**Implied-in-Fact Assignment**

Even without a written assignment, a company still may be deemed to own an employee's invention if there was an implied-in-fact assignment of the invention. Courts have found implied-in-fact assignments when the employee was hired for the purpose of inventing, or when the employee was assigned the task of inventing a specific item, process or method.

Both circumstances are, of course, fact specific and leave room for interpretation and litigation. Simply hiring an employee, even a scientist, for a position which could involve inventing may not be sufficient to constitute hiring for the purpose of inventing. Further, an implied-in-fact assignment can be rebutted. In a recent case, an employee was (arguably) hired and/or assigned to invent, but was presented with an assignment agreement and refused to sign. The court found that the employee's refusal to sign the agreement meant that the parties had failed to reach the "meeting of the minds" necessary to imply an assignment. The fact-dependent and rebuttable nature of an implied-in-fact assignment leaves uncertainties concerning patent ownership. Consequently, an acquirer or investor should be wary if a target company does not have written assignments of inventions from its employees.

Absent a written or implied-in-fact assignment, the company may have shop rights in an invention made by an employee using the company's facilities and materials. Shop rights are fact specific. They depend upon the employee using the company's shop, the company's materials, or the company's time. Courts have given various rationales for shop rights, including implied contract principles, estoppel, fairness and equity.

**Shop Rights**

Shop rights are, in essence, only a defense to infringement claims: the company ends up with a non-exclusive, royalty-free license to use the invention in its business. The employee owns the patent rights and may freely license or assign them to third parties (including competitors of the company). In the case of joint inventions, the multiplicity of inventors increases the likelihood of licenses or assignments to third-party competitors.

**Due Diligence Issues**

A potential acquirer may want to consider the following questions and issues, among others, in due diligence:

- Has each current and former employee executed an assignment of inventions to the company? Check the assignment forms for handwritten changes.
- What are the key inventions? Who invented them and what were the circumstances? Was the inventor a current or former employee? Was it a joint invention?
- Was the employee (i) hired to invent, or (ii) assigned to invent the specific item, process, or business method? How were those things documented and/or communicated to the employee?
- Was the invention made in the company's shop? On company time? Did the company provide any assistance with the invention (financial or otherwise) or install/implement the invention in its business?
- Has the invention been patented? Who owns the patent?
- Has there been a waiver of shop rights? Has the company been paying royalties to the inventor, or otherwise acting as if the company is not the owner of the invention or does not otherwise have rights to it?
- Have the rights to the invention come to the company by means of a merger, an acquisition or a joint venture? The rights may be limited based upon the manner in which the predecessor obtained them.

**What an Acquirer Might Do**

If a target company does not have written, effective assignments of inventions from its employees, a potential acquirer may pursue a number of courses to address the issue of ownership of patent rights. The most obvious, and probably the most effective, action is to condition closing, or even signing (depending on the stage of the transaction) on the target company obtaining a written assignment from all current employees of all business-related inventions made during their employment. The company may have to pay additional consideration to the employees for such assignments to be enforceable. (Whether continued employment constitutes sufficient consideration to render that type of agreement enforceable is a matter of state law.)

This does not, however, solve the problem of inventions made by former employees. While an employer could seek similar agreements from former employees, approaching such individuals to relinquish intellectual property rights may prove a dangerous proposition for the company. Alternatively, the acquirer could include in the definitive agreement extensive representations, warranties and indemnifications regarding inventions and ownership of patent rights. The acquirer also could decide to take the risk with regard to ownership of patent rights, and rely on the shop rights doctrine to provide the successor entity with the right to use employee inventions.

In extreme cases, the acquirer may choose to focus (post-acquisition) on negotiating favorable license agreements (including low royalty payments) with the inventors (perhaps funded by a purchase price reduction). Finally, if the concerns over ownership of patent rights are too great (and a potential acquirer has the right to do so), the potential acquirer may decide to abandon the transaction altogether.

**Strategies and Suggestions**

The likelihood of a company having less than sole rights of ownership in the inventions of its employees is high. If the company has not routinely obtained written assignments from all employees, the company may have only shop rights.

Awareness of the issue may be half the battle. A company can protect its ongoing business as well as position itself for potential significant business transactions by proactively obtaining written assignment agreements from its employees. Even if not currently contemplating a significant transaction, a company should investigate ownership issues relating to inventions. Such an investigation should determine what rights the company obtained by assignment, and whether its conduct might result in mere shop rights rather than sole ownership.

In a significant business transaction, the company and the acquirer or investor should include patent counsel in the diligence team and as a reviewer of applicable representations and warranties. An acquirer also should consider using an express reference to shop rights in representations and warranties it hopes to receive. That type of specific reference may trigger the appropriate level and scope of inquiry on the part of the company giving the representations.

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(2) Banks v. Unisys Corp., 228 F.3d 1357 (Fed. Cir. 2000).